No. 90-1943

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1991

In re

PRUDENTIAL LINES, INC.,

Debtor.

PSS STEAMSHIP COMPANY, INC.,

Petitioner,

against

THE UNOFFICIAL COMMITTEE OF UNSECURED CREDITORS,

and

COLD SPRING SHIPPING, L.P.,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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June 17, 1991

QUESTIONS PRESENTED

1. When a group of corporations files consolidated income tax returns and the Internal Revenue Code allocates to the parent corporation the federal tax deduction resulting from net operating losses generated by its subsidiaries, if a subsidiary becomes bankrupt, is a bankruptcy court empowered by section 541 of the Bankruptcy Code to award the parent's tax deduction to the subsidiary's creditors as "property" of the subsidiary's bankruptcy estate?

2. Did Congress grant bankruptcy courts the equitable power to permanently enjoin a debtor's non-bankrupt owner from taking a worthless stock deduction on its federal income tax return with respect to its stock in the debtor?

3. Was the Court of Appeals correct to extend this Court's holding in *Segal v. Rochelle*, 382 U.S. 375 (1966) to apply to NOL carryforwards and corporations filing consolidated returns, when Congress itself, in codifying *Segal*, confined it to its actual holding?

LIST OF PARTIES

The caption of this Petition lists all the parties to this Petition and to the proceeding before the United States Court of Appeals for the Second Circuit.

RULE 29.1 LISTING

The corporate parents of petitioner PSS Steamship Company, Inc. ("PSS") are SMC Shipping Co. and Admiralty Enterprises, Inc. PSS's subsidiaries are Prudential Lines, Inc. and Vessel Charters, Inc.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PRELIMINARY STATEMENT

Petitioner PSS Steamship Company, Inc. ("PSS") respectfully submits this Petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit (the "Court of Appeals").

OPINIONS BELOW

The opinion of the Court of Appeals (the "Opinion") is reported in 928 F.2d 565 (2d Cir. 1991) and appears as Appendix A. The Opinion and Decision of the United States District Court for the Southern District of New York is reported at 119 B.R. 430 (1990) and appears as Appendix B. The Orders of the United States Bankruptcy Court for the Southern District of New York are reported at 114 B.R. 27 (Bankr. S.D.N.Y. 1989) and 107 B.R. 832 (Bankr. S.D.N.Y. 1989) and appear as Appendices C and D, respectively.

JURISDICTION

Jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1254(1). The date of the entry of the judgment of the United States Court of Appeals for the Second Circuit is March 20, 1991.

STATUTES AND RULE PROVISIONS INVOLVED

11 U.S.C. § 346 - Reproduced as Appendix F
11 U.S.C. § 362 - Reproduced as Appendix G
11 U.S.C. § 541 - Reproduced as Appendix H
26 U.S.C. § 165(g)(1) - Reproduced as Appendix I

STATEMENT OF THE CASE

This Petition concerns two issues: 1) whether section 541 of the Bankruptcy Code, defining "property of [the bankruptcy] estate," is broad enough to include as estate property the federal tax deduction associated with a net operating loss carryforward ("NOL") generated by the corporate debtor, even though the Internal Revenue Code allocates the use of that deduction to the non-bankrupt parent corporation; and 2) whether a bankruptcy court may permanently enjoin a non-bankrupt corporate parent from taking a worthless stock deduction with respect to its stock in a bankrupt subsidiary. The case thus involves significant questions concerning whether a bankruptcy court has the intrinsic power, because of the Bankruptcy Code's general policy of fostering the rehabilitation of debtors by construing "property of the estate" broadly, to enjoin a non-debtor from taking tax deductions that the Internal Revenue Code clearly allocates to it, rather than to the debtor.

To resolve these two issues, the Court must clarify its decisions in *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983) and *Segal v. Rochelle*, 382 U.S. 375 (1966). In *Whiting Pools*, the Court held that section 541(a)(1), defining the estate as comprised of "all legal or equitable interests of the debtor in property," should be construed broadly, since "[t]he reorganization effort would have small chance of success . . . if property essential to running the business were excluded from the estate." 462 U.S. at 203 *citing* 6 J. Moore & L. King, Collier on Bankruptcy ¶ 3.05, p. 431 (14th ed. 1978). *Segal*, decided prior to the Bankruptcy Code and codified by it, held that the tax benefit of an NOL carry*back* on an *individual* tax return did constitute property of the individual's bankruptcy estate. However, neither *Segal*, nor the Bankruptcy Code in codifying *Segal*, dealt with the circumstances found here: an NOL carryforward and an affiliated group of corporations filing consolidated returns, where the Internal Revenue Code allocates

all tax benefits to a party (the corporate parent) not in bankruptcy. This Petition argues that the Bankruptcy Code may not be construed to empower a bankruptcy court to enjoin a non-debtor from filing an accurate tax return. Where the Internal Revenue Code allocates a tax deduction to a parent, a bankruptcy court may not reallocate that deduction to a subsidiary, either because the subsidiary is in bankruptcy, or because doing so favors the reorganization process.

A. The Parties

PSS is one of a group of affiliated companies. One former subsidiary, Prudential Lines, Inc. ("PLI"), provided U.S.-flag shipping between the U.S. and Europe. In 1986 an involuntary Chapter 11 petition was filed against PLI. The Official Committee of [PLI's] Unsecured Creditors and a company (Cold Spring Shipping, L.P.) that had recently purchased a participation interest in one of the unsecured claims against PLI's estate, jointly submitted a reorganization plan and commenced this adversary proceeding against PSS, seeking to enjoin PSS, preliminarily and permanently, from declaring a $38.9 million worthless stock deduction with respect to its stock in PLI on its 1988 tax return (which was then due).

B. The Proceedings Below

The complaint was in three counts. The first two alleged that PSS, as PLI's sole stockholder, owed a fiduciary duty to PLI and its creditors, and that PSS's announced intention to take the worthless stock deduction constituted a breach of that duty. The creditors alleged that if PSS carried out its announced intention to take the deduction for tax year 1988, the Internal Revenue Code would limit any tax deduction arising out of a $74 million NOL carryforward generated by PLI. The creditors asserted that that deduction belonged to PLI, and that by taking the worthless stock deduction PSS was attempting to deprive the creditors of the tax benefit of the NOL

carryforward, in order to defeat the creditors' reorganization plan.[1]

While Counts 1 and 2 both alleged wrongful motivation, Count 3 turned entirely on the issue of statutory construction now the subject of this Petition: Whether the Bankruptcy Code empowered the Bankruptcy Court to enjoin PSS from taking its worthless stock deduction. Count 3 alleged that the tax deduction associated with the NOL carryforward belonged to PLI rather than PSS and that since, further, PSS's taking the worthless stock deduction on its 1988 return would eliminate the NOL-related deduction, PSS was "exercis[ing] control" over "property of [PLI's] estate," thus subjecting that tax deduction to the automatic stay of 11 U.S.C. § 362.[2]

The Bankruptcy Court, following document production and depositions, held a day-long testimonial hearing. Following that hearing it dismissed the creditors' two state-law counts as unproven. With respect to Count 3 it stated that that claim turned on two legal issues of first impression: whether the NOL carryforward is "property of the estate" within the meaning of 11 U.S.C. § 541, and whether PSS's exercising its worthless stock deduction violated the automatic stay.

The Bankruptcy Court held that the NOL-related deduction was PLI's property, and that PSS's worthless stock deduction was therefore subject to the stay under 11 U.S.C. § 362. The Court based its decision on the legislative history of section

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[1] The Bankruptcy Court summarized how 26 U.S.C. § 382(g)(4)(D) causes a worthless stock deduction taken under 26 U.S.C. § 165 to limit of the tax benefit arising out of an NOL.

[2] Section 362 mandates a stay with respect to seven categories of events, including: "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate . . . ." 11 U.S.C. § 362(a).

541, on its reading of *Whiting Pools* and *Segal*, and on Justice Jackson's dissent in a seminal case: *Western Pacific Railroad Corp. v. Western Pacific Railroad Co.*, 197 F.2d 994 (9th Cir. 1951), *reh'g denied*, 197 F.2d 1012, *vacated & remanded*, 345 U.S. 247, 273-77 (Jackson, J., *dissenting*), *prior opinion aff'd*, 206 F.2d 495 (9th Cir.), *cert. denied*, 346 U.S. 910 (1953), *reh'g denied*, 346 U.S. 940 (1954).[3]

The Bankruptcy Court consolidated the preliminary injunction hearing into a trial on the merits, confirmed the creditors' plan to reorganize PLI, carved out PSS's right to appeal the injunction, and changed the stay into a permanent injunction. The District Court and Court of Appeals affirmed.

C. The Issues

The Bankruptcy Court's injunction is momentous, not only because of the value of the NOL carryforward ($74 million) and of the worthless stock deduction ($38.9 million) involved, but because of its far-reaching implications in permitting bankruptcy courts to reallocate federal tax benefits.[4]

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[3] Justice Jackson, observing that state-law questions of unjust enrichment had been "scrambled" in the case with federal bankruptcy and consolidated-return issues, indicated that the decision of the Court of Appeals for the 9th Circuit (a decision heavily relied upon by PSS below) should have been accepted for review and reversed, since a corporation with a tax loss should be compensated by an affiliate corporation with an otherwise taxable gain, because the tax loss has "value." 345 U.S. at 276. PSS argues herein that, whatever the "value" of the tax loss PLI generated, neither the Bankruptcy Code nor the Internal Revenue Code provides any authority for the proposition that it is PLI's "property."

[4] The significant implications of the case have already been recognized by the tax and bankruptcy bars. *See, e.g.*, E. Pisem & P. Glicklich, "Was the Bankruptcy Court Lost at Sea? Prudential Lines Collides With the Internal Revenue Code," *American Bankruptcy Institute Newsletter*

(continued...)

I. The injunction herein signals far wider powers for bankruptcy courts than Congress intended, since it is based upon a construction of the term "property" that abrogates the consolidated corporate tax return provisions (26 U.S.C. §§ 1501-1504 & 1554) of the Internal Revenue Code. Under those provisions, when a group of affiliated corporations elects to file consolidated returns, an NOL generated by one subsidiary in the group does *not* give rise to any federal tax deduction or other economic benefit for that subsidiary, even if it is in bankruptcy. Rather, the "common parent" responsible for filing the consolidated return has absolute control over the use of that deduction. The only exceptions to this principle are where, by taking the deduction for itself, the parent breaches an agreement previously made with the complaining subsidiary to allocate the tax loss to that subsidiary (and there was no such agreement here), or where taking the tax deduction associated with the subsidiary's NOL constitutes, under the facts of the particular case, a breach of a fiduciary duty owed to the subsidiary (and PSS prevailed on that disputed issue here). In short, where the creditors of a bankrupt subsidiary fail to prove their claims of fiduciary breach, the Internal Revenue Code--not the Bankruptcy Code--controls, and allocates to the parent absolute authority over the tax deduction associated with the bankrupt subsidiary's NOL carryforward. There is *nothing* in the Bankruptcy Code or its legislative history that permits a bankruptcy court to ignore this principle by bringing the *parent's* federal tax deduction within the ambit of the subsidiary estate's "property."

II. Even accepting *arguendo* that a bankrupt subsidiary has some cognizable interest in the federal tax deduction to be taken with respect to an NOL carryforward it generated (and,

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[4](...continued)
(May/June 1990), reprinted in *Tax Notes*, Sept. 17, 1990 ("Pisem & Glicklich"). (68a)

as indicated above, the Internal Revenue Code dictates a contrary result), and assuming that section 382(g)(4)(D) of the Internal Revenue Code causes a parent's worthless stock deduction to limit the NOL-related deduction, the Bankruptcy Court had no authority to enjoin PSS, a non-bankrupt, from filing an accurate tax return. A worthless stock deduction taken under 26 U.S.C. § 165 is a federal tax attribute pertaining to the stockholder's income tax return, one in which the subsidiary whose stock has become worthless has no cognizable interest. *See Pisem & Glicklich*, 68a. A bankruptcy court's equitable powers do not extend to enjoining a non-bankrupt from filing an accurate tax return. Nor should it be a feature of federal bankruptcy policy, absent some clear congressional directive, to punish the non-bankrupt parent of a bankrupt subsidiary by wiping out its federal tax deduction, so that the subsidiary's creditors may enjoy a $74 million tax benefit which *itself* was clearly allocated by Congress to the parent.

III. *Segal* involved individuals and carryback refunds. It applied neither to corporations filing consolidated returns, nor to carryforwards. Congress codified *Segal* in 11 U.S.C. § 346(i). That codification provides that it applies only to individuals, while 11 U.S.C. § 346(a) provides that all of the provisions of section 346 are subject to the Internal Revenue Code (including, presumably, its provisions pertaining to consolidated returns). Absent a clear directive that Congress desired, either in section 346(i) or in any other provision of the Bankruptcy Code, to repeal the laws governing consolidated returns, the courts may not construe any provision of the Bankruptcy Code as abolishing any provision of the IRC "by implication."

REASONS FOR GRANTING THE PETITION

I. THE TAX BENEFIT OF AN NOL CARRYFORWARD IS NOT THE DEBTOR'S "PROPERTY" IF THE DEBTOR IS PART OF A GROUP FILING CONSOLIDATED RETURNS

11 U.S.C. § 541 states that the commencement of a bankruptcy case creates an estate comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Section 541 is "not intended to expand the debtor's rights against others more than they exist at the commencement of the case. . . ." H. Rep. No. 595, S. Rep. No. 989, 95th Cong., 1st Sess., *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5868. If something was not the debtor's "property" at the time the petition is filed, it does not become property of the debtor's estate thereafter. *See Butner v. United States*, 440 U.S. 48, 55 (1979), *quoting Lewis v. Manufacturers Nat'l Bank of Detroit*, 364 U.S. 603, 609 (1961).

With respect to tax matters, a bankruptcy court has no power to adjudicate tax liabilities other than those of the debtor, even if the tax consequences for the non-debtor arise from the debtor's activities or have an effect on the reorganization process. *See, e.g., American Principals Leasing Corp. v. United States*, 904 F.2d 477, 481 (9th Cir. 1990). It may not expand its jurisdiction to become a "second tax system" by imposing "its equitable notions of justice." *In re Vermont Fiberglass, Inc.*, 88 B.R. 41, 44 (D. Vt. 1988) (citing authority).

At the commencement of its bankruptcy case PLI had no cognizable rights of any kind, either in PSS's worthless stock deduction or in the tax deduction associated with the NOL carryforward, since the Internal Revenue Code allocates both of those tax benefits to PSS.

Congress has permitted the use of consolidated tax returns by qualifying corporate groups since 1917. *See generally Regal, Inc. v. Commissioner*, 53 T.C. 261, 264 n.2 (1969), *aff'd*, 435 F.2d 922 (2d Cir. 1970). The current statute is set forth in 26 U.S.C. §§ 1501-1504 & 1552. The consolidated return is filed on the same form (1120) used by corporations filing separate returns, and reports the aggregate of income, deductions, and resulting tax liability of the affiliated group.[5]

NOLs are among a number of tax attributes computed on a consolidated basis.[6] All are deducted from the consolidated income listed by the corporation responsible for filing the return (the "common parent"). 26 U.S.C. § 6062; U.S. Treas. Reg. §§ 1.1502-75(h)(1) & 1.1502-77(a); *see Craigie, Inc. v. Commissioner*, 84 T.C. 466, 473 (1985). The common parent *is* "the taxpayer." *See generally* U.S. Treas. Reg. 1.1502-77(a); *J&S Carburetor Co. v. Commissioner*, 93 (CCH) Tax Ct.

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[5] A group of corporations does not qualify for consolidated treatment merely by being affiliated under state law or even by being a "controlled" group for federal tax purposes; it must be an "affiliated group" as defined in 26 U.S.C. § 1504(a). *Ray Engineering Co. v. Commissioner*, 347 F.2d 716 (3d Cir. 1965). The provision leaves no room for judicial construction. *Id.* at 716. *See also* U.S. Treas. Reg. § 1.1502-75(b)(1).

[6] 26 U.S.C. § 172 permits a business to take deductions for certain operating losses incurred in other years. Section 172(b) allows such losses to be carried back to prior taxable years to the extent that they offset taxable income, then forward to subsequent taxable years to the extent of taxable income. 26 U.S.C. § 172(b)(1)(A) & (B). Carry-forwards were first permitted in the Revenue Act of 1921 (ch. 136, § 204(b), 42 Stat. 227, 231 (Part I)); carrybacks in the Revenue Act of 1942 (ch. 619, § 153(b), 56 Stat. 798, 847-48 (Part I)). Other deductions to be consolidated include: net losses under 26 U.S.C. § 1231, consolidated charitable contribution deductions under 26 U.S.C. § 170, and consolidated "dividends received" deductions under 26 U.S.C. § 243. *See* U.S. Treas. Reg. §§ 1.1502-12(h), 1.1502-21(a), (b).

Rpts. Dec. 45, 912 (1989); National Office Technical Advise Memorandum 8145027 (July 31, 1981) (construing U.S. Treas. Reg. § 1.1502-77(a)).

26 U.S.C. § 1501 requires that all members of the filing group consent to be governed by the consolidated return regulations when the first consolidated return is filed. Upon the consent of each member, the commitment to consolidated-return treatment is binding on each, and none may subsequently file a separate return of its own without first seeking and obtaining IRS permission. U.S. Treas. Reg. § 1.1502-77(a); U.S. Treas. Reg. § 1.1502-75(a). *See generally Jump v. Manchester Life & Cas. Mgt. Corp.*, 438 F. Supp. 185 (E.D. Mo. 1977), *aff'd*, 579 F.2d 449, 453-54 (8th Cir. 1978); *Koscot Interplanetary, Inc. v. Glenn W. Turner Enterprises, Inc. (In re Koscot Interplanetary, Inc.)*, 1976-1 (CCH) U.S. Tax Cases at 84,187-84,188.

Consistent with the general principle that bankrupt corporations are treated the same for tax purposes as other corporations,[7] the bankruptcy of one of the subsidiaries does not cause deconsolidation and permit it to file its own return, nor cause it to recognize income and deductions of its own.[8]

The group of which PSS and PLI were members has filed consolidated returns since 1976. Having elected consolidation at that time, all members of the group became obligated under the Internal Revenue Code to continue consolidated treatment.

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[7] 11 U.S.C. §§ 346(b)(2) & (c)(1); 26 U.S.C. § 1399. *See generally Commissioner v. Trustee, Sapphire S.S. Lines, Inc. (In re Sapphire S.S. Lines, Inc.)*, 762 F.2d 13 (2d Cir. 1985).

[8] U.S. Treas. Reg. § 1.1502-75(h)(3); Rev. Rul. 63-104, 1963-1 C.B. 172; *see also In re Koscot Interplanetary, Inc.* (debtor may not deconsolidate return to obtain tax benefit of NOL carryback refund); *Trinity Buildings Corp. v. Commissioner*, 40 B.T.A. 1315 (1939).

Neither PLI nor any other group member ever sought to deconsolidate. Nor did PLI's bankruptcy itself cause such deconsolidation. *See generally In re Koscot Interplanetary, Inc.* Thus, the law applicable to consolidated returns *must* apply, and the cases construing the use of NOLs in the context of consolidated returns *must be* dispositive.

The seminal case on this issue is *Western Pacific*. A subsidiary went bankrupt and its parent took a worthless stock deduction. The subsidiary experienced net earnings while in bankruptcy, while the non-bankrupt parent suffered losses. The subsidiary's directors, wishing to utilize the parent's tax losses for the subsidiary's benefit, filed a consolidated return, just as the two corporations had done for many years. The parent and its minority shareholders sued, alleging that the subsidiary's arrogating to itself the benefit of the parent's tax losses in order to offset its own income, without compensating the parent for such use, constituted a breach of duty. The court held, however, that the privilege of filing consolidated returns *and to take the tax benefits thereof* belonged to the party traditionally responsible for filing the return (there, the subsidiary), and not to the particular affiliate (there, the parent) that generated the loss. Significantly, the court said:

> If the positions of the corporations were reversed and the [bankrupt] subsidiary had a loss and the parent had income, [subsidiary] *would have been obliged to file consolidated returns to enable* [the parent] *to make use of the loss*. Indeed, this very thing had occurred in previous years of the affiliation and [the parent] had

> effected substantial tax savings [for *itself*] . . . by reason of filing consolidated returns.

Id. at 1004. Further:

> "[W]e think it should be observed that in the ordinary case the fact that one subsidiary contributes a particular income deduction to a consolidated return *does not in itself entitle that subsidiary to the benefits of the reduced taxes* resulting from the deduction. Where tax reductions are possible from filing a consolidated return, they ordinarily are due to a number of factors contributed by the various members of the consolidated group, including, among others, earnings, and excess profits tax credits, as well as income deductions."
>
> There is nothing in the [Internal Revenue] Code or Regulations that compels the conclusion that a tax saving must or should inure to the benefit of . . . the company which has sustained the loss that makes possible the tax saving.[9]

These passages have been widely quoted and debated in the courts. *Western Pacific* is summarized and discussed in *In re All Products Co.*, 32 B.R. 811 (Bankr. E.D. Mich. 1983). The issue there was:

> whether a parent corporation who files a consolidated return for an affiliated group and obtains a tax saving from the use of a [bankrupt] subsidiary's operating loss

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[9] *Id.* at 1003-4, *quoting In re Cities Service Co. and Cities Service Refining Corp.*, Securities & Exchange Commission Findings and Opinion, Holding Co. Act of 1935 Release no. 5535, File 70-988 at 5 (Jan. 3, 1945) (emphasis in original).

> must compensate [the creditors' committee of that bankrupt] subsidiary for the use of that loss.

Id. at 812. The court squarely held that the parent is under no duty to compensate the creditors' committee for the use of the debtor's tax losses, since there was no equitable basis for imposing a judge-made rule of fairness which would be inconsistent with the Internal Revenue Code.

To the same effect are *Jump v. Manchester Life & Cas. Management Corp.*, 438 F. Supp. 185 (E.D. Mo. 1977), *aff'd*, 579 F.2d 449 (8th Cir. 1978) (NOL carryforward generated by insolvent subsidiary not an "asset" of the subsidiary, so that parent's use of the NOL for its own purposes on consolidated tax return did not constitute conversion, *citing* U.S. Treas. Reg. §§ 1.1502-75(a), (c)(1)(i)); *Case v. N.Y. Central Railroad Co.*, 232 N.Y.S.2d 702 (1962), *rev'd*, 19 A.D.2d 383, 243 N.Y.S.2d 620 (1st Dep't 1963), *rev'd*, 15 N.Y.2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643, *rearg. denied*, 16 N.Y.2d 618, 261 N.Y.S.2d 1028, 209 N.E.2d 126 (1965) (no evidence to suggest that tax allocation agreement unfair when made); *M & M Transportation Co. v. U.S. Industries, Inc.*, 416 F. Supp. 865 (S.D.N.Y. 1976) (parent corporation owns tax refund for losses and credits generated by subsidiary when the parties were filing consolidated returns); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967) (courts not empowered to reallocate tax benefits arising out of consolidated tax returns, absent tax allocation agreement); *In re Koscot Interplanetary, Inc.* (subsidiary in Chapter XI may not deconsolidate consolidated tax return to take NOL carryback refund; "appropriate manner to file a Federal tax return is a subject matter exclusively governed by tax laws . . . and clearly not by the Bankruptcy Act"); and *In re Coral Petroleum, Inc.*, 60 B.R. 377, 388-89 (Bankr. S.D. Tex. 1986) ("no reasonable expectation by [subsidiary] that it would ever be compensated for use of its losses by actual payment") (citing authority).

In all of these cases, the courts enforced the consolidated return laws as enacted, against demands for a reallocation that the debtor or its creditors considered to be more "fair." However, Congress, in the Internal Revenue Code, has decided what is fair.[10] Under the law of consolidated tax returns, the federal tax deduction resulting from an NOL carryforward generated by a subsidiary does not belong to that subsidiary, irrespective of its bankruptcy, but to the affiliate filing the consolidated return.

II. A PARENT'S WORTHLESS STOCK DEDUCTION IS NOT PROPERTY OF A BANKRUPT SUBSIDIARY'S ESTATE

The deduction PSS wishes to take concerns stock in the debtor owned by PSS. It is elementary that a corporate debtor has no "property" interest in its own shares. *See, e.g., Uranga v. Geib (In re Paso Del Norte Oil Co.)*, 755 F.2d 421, 424 (5th Cir. 1985). The stock of PLI (including PSS's $38.9 million tax basis in that stock) is PSS's "property," not PLI's.

Stock becomes worthless because one's investment in it has been lost. 26 U.S.C. § 165 provides for a deduction for any loss sustained during the taxable year, in an amount equal to the adjusted tax basis of the asset. A bankruptcy court is without authority to enjoin conduct (*i.e.*, the filing of an accurate tax return) that the Internal Revenue Code *mandates* be done. PSS lost $38.9 million by investing in PLI, and is obliged to report the loss for the year (1988) in which it occurred. It is PSS's tax loss, not PLI's.

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[10] Under 26 U.S.C. § 1504(a)(2), for instance, a common parent need own only *80* percent of the subsidiary's stock in order to qualify for consolidated treatment, yet it may take a full *100* percent of the tax deduction resulting from the subsidiary's NOL.

Each taxpayer is required to file tax returns that accurately report all information required by the Internal Revenue Code; the failure to do so constitutes a felony. 26 U.S.C. §§ 6011(a); 6012(a)(2); 7206(1). A taxpayer must take deductions in the appropriate year. 26 U.S.C. §§ 461(a); 165(g)(1); U.S. Treas. Reg. §§ 1.1502-75(a), (c)(1)(i). Consistent with this fundamental requirement, a worthless stock deduction must be taken in the year in which the stock actually became worthless. *See Clark v. Welch, 43-1 U.S.T.C. ¶ 9241* (D. Mass. 1943), *aff'd*, 140 F.2d 271 (1st Cir. 1944); *Lawson v. Commissioner*, 42 B.T.A. 1103, 1107 (1940); *Taylor v. Commissioner*, 37 B.T.A. 1055 (1938).

The facts adduced at the evidentiary hearing showed (and the Bankruptcy Court expressly found) that PSS's directors had concluded in good faith and on advice from PSS's counsel and its accountants, that PSS's stock in PLI had become worthless in 1988. By enjoining PSS from filing an accurate tax return for that year, the Bankruptcy Court has placed PSS in an untenable position.

The automatic stay provision (§ 362) of the Bankruptcy Code was intended to establish the federal preemption of creditors' common-law rights while also giving the debtor a temporary "breathing spell" to facilitate the reorganization process. Declaring an accurate federal tax deduction to be subject to the stay, then making that stay permanent, serves neither the preemption nor the "breathing spell" function. What the injunction herein has done is not the short-term suspension of another's rights to deal in property of the debtor, but a *permanent* denial of a non-bankrupt's federal privilege and duty regarding the tax ramifications of its own property: its stock in the debtor. Nowhere is it suggested that Congress intended section 362 to apply to a worthless stock deduction taken by the debtor's owner.

III. *SEGAL* AND ITS CODIFICATION DO NOT APPLY TO CORPORATE NOL CARRYFORWARDS

In enacting the Bankruptcy Code, Congress obviously did not intend that bankruptcy courts should help creditors reorganize a debtor by giving them as "property" future federal tax benefits that the Internal Revenue Code allocates to others. Nor does this Court's decision in *Segal*, subsequently codified as 11 U.S.C. § 346(i), support such a view.

Segal involved loss carryback refunds on individual returns. The Court, "conceding the question to be close," held that a "loss-carry*back* [n.b.] refund claim" was "property" within the meaning of the predecessor of section 541. The Court, per Justice Harlan, proceeded to contrast carrybacks with carryforwards:

> We are told that if this loss-carryback refund claim is "property," that label must also attach to loss-carryovers. . . . Without ruling in any way on a question not before us, it is enough to say that a carryover into post-bankruptcy years *can be distinguished conceptually as well as practically.* The bankrupts . . . [unlike PLI in this case] *had both prior net income and a net loss* when their petitions were filed and apparently *would have deserved an immediate refund* had their tax year terminated on that date; by contrast, the supposed loss-carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all.

382 U.S. at 381 (emphasis supplied).

Since it was issued, *Segal* has been variously interpreted. It is *correctly* construed in *Davis v. Commissioner*, 69 T.C. 814 (1978) as not applying to carryforwards. The Tax Court said:

> . . . it is vital to a full understanding of [*Segal*] to emphasize that the question was the ownership of the *claim for refund* resulting from the net operating loss carryback, not the proper party entitled to utilize [the NOL].

Id. at 827 (emphasis supplied). Thus, an NOL carryback constitutes "property" because it results from losses *and offsetting income* by the debtor on his own return. *Davis* goes on to state:

> If the steps in logic applied by the Supreme Court are scrutinized and compared to a net operating loss carryover, it is apparent that *the net operating loss carryover cannot constitute property* and *is not transferable to the trustee in bankruptcy.* In the instant case, there could be no claim for refund because the net operating loss could not be carried back; petitioners sustained net operating losses and paid no taxes for the three prior taxable years.

Id. at 2430 (emphasis supplied).

PLI could not carry back its losses because it sustained losses in all of the available carryback years.[11] It thus could never have obtained a refund, even if the consolidated return regulations would allocate such a refund to it (and they do not).

Refunds are essentially checks or the right to checks from the U.S. Treasury. The cases stress the "check-like" nature of a carryback. *See, e.g., In Re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262, 264 n.4 (9th Cir.), *cert. denied sub nom. Western Dealer Management Inc. v. England*, 412 U.S. 919

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[11] An NOL carryforward is available for 15 years, but may not be used unless all carrybacks are exhausted. 26 U.S.C. § 172(b)(1)(B).

(1973); *Coral Petroleum*, 60 B.R. at 391; *All Products*, 32 B.R. at 814. These authorities show that the right to a tax-based refund check from the IRS, arising out of the debtor's *own* retrospective losses *and income*, is simply not the same thing as a future federal tax benefit.[12]

Congress codified *Segal* in the Bankruptcy Code but in doing so did not *expand* it. Section 346(i) provides that it applies *only* to individuals. Collier's Comment to section 346 states that it codifies *Segal* "on carry*backs*" (emphasis supplied).[13]

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[12] *See* Pisem and Glicklich, App. E at 76-77:

> *Prudential Lines* is disturbing to tax practitioners . . . . [T]he holding that a net operating loss [carryforward] is property--rather than a mere inchoate right or potential to reduce future taxes, if, as, and when taxable income is generated in the future--seems erroneous. In any event, reliance by the bankruptcy court on cases dealing with tax refunds due to the carryback of a net operating loss, like *Segal* and *Bob Richards*, seems misplaced. The future tax benefits of an NOL are entirely speculative because they depend on the taxpayer's realizing net income in future years. These potential benefits are fundamentally different from the right to a refund attributable to the carryback of an NOL.

And see *M & M Transportation Co.*:

> In essence, the Court is herein asked to declare the parties' rights to an "asset" that does not presently exist and whose future existence is not a certainty. To be sure, plaintiff may be pregnant with confidence that the subject refund eventually will be allowed. That condition, however, is not enough to permit, in effect, a decree of custody over what is now no more than an expectancy that might never be realized.

416 F. Supp. at 870.

[13] The legislative history similarly states that *Segal* was not expanded in the codification: "The result of *Segal* . . . is followed, and the *right to a*

(continued...)

And Section 346(a) makes clear that all of section 346 is subject to the Internal Revenue Code (including, presumably, the law of consolidated returns).

Nor in codifying *Segal* did Congress make section 346(i) a phantom "property" provision which *sub silentio* expands the definition of property in section 541. Section 346 does not provide that an NOL carryover is "property"; it expressly calls it a "tax attribute." 11 U.S.C. § 346(i)(1). Section 346 does not reattribute to the debtor any loss carryover or other tax attribute that did not belong to the debtor prior to its bankruptcy.

When it codified *Segal*, Congress could have expanded it to include NOL carryforwards on separate corporate returns and/or on consolidated returns. It did not. Like this Court when it issued *Segal*, Congress was aware of *Western Pacific* (including Justice Jackson's dissent ascribing "value" to the tax loss generated by one of several corporations filing consolidated returns).[14] Congress could have added a provision dealing with NOL carryforwards to the general definition of "property" (§ 541). It could also have carved out a bankruptcy exception to the consolidated return rules. It did none of these things, however. Instead, it codified *Segal* (which involved individuals), by drafting a provision (§ 346(i)) dealing with individuals. With neither statutory language nor legislative history showing that Congress desired either to expand *Segal* to apply to NOL carryforwards by corporations filing consolidated returns, or to codify

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[13](...continued)
refund is property of the estate." H. Rep. No. 595, S. Rep. No. 989, 95th Cong., 1st Sess., *reprinted in* 1978 U.S. Code Cong. & Admin. News. 5787, 5868, 6323 (emphasis supplied).

[14] Justice Jackson likened tax benefits to a treasure chest that requires two keys: a tax loss and an otherwise taxable gain. Since both keys are required, each -- he suggested -- has value. *See* 345 U.S. at 277.

Justice Jackson's dissent, the Bankruptcy Court exceeded its powers by expanding section 541's description of "property" to reach the circumstances herein.[15]

IV. IN THE CONTEXT OF CONSOLIDATED RETURNS, THE NOL COMES WITHIN AN EXPRESS EXCLUSION FROM "PROPERTY"

Section 541 brings into the estate all "interests of the debtor in property." Congress wished to define "property" broadly, to include everything of value. *See generally Whiting Pools Inc.*, 462 U.S. at 204. Yet this Court has not yet answered whether a federal tax attribute can be "property."[16]

Section 541 by its terms excludes from "property" "any power that the debtor may exercise solely for the benefit of an entity other than the debtor," as well as "any equitable interest" in "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest." 11 U.S.C. §§ 541(b)(1) and 541(d). A host of state-

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[15] *See generally United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 373 (1988) (congressional intent to be found in the provision dealing with the subject at hand, not by implications in obscure language in another provision); *Midlantic Bank v. N.J. Dep't of Environmental Protection*, 474 U.S. 494, 501 (1986) (congressional intention, if present, will be expressed, and not "left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt") (*quoting Swarts v. Hammer*, 194 U.S. 441 (1904)).

[16] The Court has clearly stated that tax benefits are not "income." *Randall v. Lofisgaarden*, 478 U.S. 647 (1986). *See also United Savings Ass'n of Texas*, 484 U.S. at 371 ("The term 'interest in property' certainly sums up such concepts as 'fee ownership,' 'life estate,' and 'security interest' more readily than it does 'right to immediate foreclosure'").

law possessory and titular interests,[17] as well as state-law property held by others in which the debtor has some kinds of "interest,"[18] are therefore excluded from estate property because the debtor does not enjoy beneficial ownership. Also excluded are federal tax funds held by the debtor but belonging under the tax laws to another.[19] Here, even if one accepts

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[17] *See, e.g., DeVita Fruit Co. v. FCA Leasing Corp. (In re DeVita Fruit Co.)*, 473 F.2d 585, 588-89 (6th Cir. 1973) (debtor/bailee's estate has no interest in bailment); *Louisiana World Exposition, Inc. v. Federal Insurance Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1400 (5th Cir. 1987) (proceeds of liability policy not property of the estate where such proceeds were payable to directors and officers); *Colin v. Fidelity Standard Mortgage Corp. (In re Fidelity Standard Mortgage Corp.)*, 36 B.R. 496 (Bankr. S.D. Fla. 1983) (debtor's supervision of mortgages held by others does not implicate any interest of debtor's estate in mortgages); *In re Venture Properties, Inc.*, 37 B.R. 175, 176 (Bankr. D.N.H. 1984) (debtor general partner's interest in property owned by the partnership insufficient to establish "legal or equitable interest" in "property" of debtor's estate); *Turner v. Lee (In re Minton Group, Inc.)*, 46 B.R. 222 (S.D.N.Y. 1985) (debtor, as general partner and 25% owner of New York partnership which owned property, did not own the property itself, so property not subject to § 362 stay).

[18] *In re M.J. Sales & Distributing Co., Inc.*, 25 B.R. 608 (Bankr. S.D.N.Y. 1982) (letter of credit secured by debtor's assets and proceeds thereof not property of its estate); *accord, Elegant Merchandising, Inc. v. Republic Nat'l Bank (In re Elegant Merchandising, Inc.)*, 41 B.R. 398 (Bankr. S.D.N.Y. 1984); *Bohemian Savings & Loan Ass'n v. Mills (In re Columbia Pacific Mortgage, Inc.)*, 20 B.R. 259, 261 (Bankr. W.D. Wash. 1981).

[19] Construing section 541, this Court recently held that money withheld by the debtor for FICA and other taxes is not property of its estate because it is held in trust for the IRS. The Court observed: "Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate'." *Begier v. Internal Revenue Service*, ___ U.S. ___, 110 L. Ed. 2d 46, 110 S. Ct. 2258 (1990). *See also John Hancock Mutual Life Ins. Co. v. Watson (In*

(continued...)

arguendo the notion that either "legal title" or "equitable interests" could ever be applied to an NOL-related tax deduction, the consolidated return regulations make clear that that deduction never "belonged" to PLI. Since PLI had no legal or equitable right to the NOL carryforward, the *only* possible construction of section 541 is that it excludes the NOL deduction at issue herein.

An additional consideration dictates the same result. The federal tax laws constitute an example (indeed, the supreme example) of comprehensive congressional regulation that gives rise to both obligations and benefits among those regulated. Even if section 541 could otherwise be reasonably construed to include federal tax deductions as property, a number of cases show that the benefits of congressional regulation are not property, at least insofar as it is established that they cannot (just as NOLs and other tax deductions clearly cannot) be bought and sold.

Congress provides comprehensive federal regulation of the airline industry, yet the benefits of that regulation have been held not to be "property" for purposes of section 541. A convenient gate-slot at an airport, for instance, is obviously an "asset" in the hands of an airline, one with a substantial, fully liquidated dollar value. Yet such gate-slot assignments do not become "property of the estate" when that airline goes bankrupt.[20] As stated in *Pension Benefit Guaranty Corp. v.*

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[19](...continued)
re Kincaid), 917 F.2d 1162 (9th Cir. 1990) (debtor's interest in ERISA pension or profit-sharing plan not property of the estate because, as spendthrift trust, debtor has extremely limited present access to corpus).

[20] In 1986 experts valued an 8:00 A.M. gate slot at National Airport in Washington, D.C. at $600,000-$750,000. Carter, "Battle For Air Slots," *Fortune*, March 3, 1986 at 80. Nevertheless, *Braniff* held them
(continued...)

Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 942 (5th Cir. 1983): "The slots are actually restrictions on the use of property--airplanes; not property in themselves. As such, they are not within the jurisdiction of the Bankruptcy Court . . . ." Other benefits of congressional regulation are similarly excluded from estate property.[21]

The consolidated return provisions, part of Congress's comprehensive structure of tax regulation, frequently give rise to disputes between private parties concerning their respective rights. As indicated above, these provisions allocate the NOL-related tax deduction to PSS. Even if this were not so, however, the Internal Revenue Code is hardly the place to start finding penumbral property rights for a debtor, absent clear provision for doing so in the Bankruptcy Code itself. If "property" is to be judicially expanded beyond what Congress specified, and even beyond the limits of "legal" and" equitable" interests in "property," tax benefits allocated by the Internal Revenue Code to non-debtors are a bad place to begin.

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[20](...continued)
not to be "property" because, among other things, they could not be bought and sold. Significantly, when in 1986 the FAA announced that henceforward gate slot assignments could be sold (14 C.F.R. § 93.221(a) (1989)), the issue of whether or not they can be property became open. *See, e.g., In re Gull Air Inc.*, 890 F.2d 1255, 1260-61 n.8 (1st Cir. 1989). It is fundamental that NOL carryforwards may not be bought and sold.

[21] *See, e.g., In re Petrusch*, 667 F.2d 297, 299-300 (2d Cir. 1981), *cert. denied*, 456 U.S. 974 (1982) (Bankruptcy Code, absent legislative history to the contrary, not presumed to transcend or supersede Norris-La Guardia Act); *accord, Crowe & Assocs., Inc. v. Bricklayers & Masons Union Local No. 2 (In re Crowe & Assocs., Inc.)*, 713 F.2d 211, 214-15 (6th Cir 1983); *Mason v. Eastman Kodak Co. (In re Parker)*, 473 F. Supp. 746, 750, (W.D.N.Y. 1979) (pension benefits regulated by Congress in ERISA not "property" for bankruptcy purposes because in ERISA Congress established a "comprehensive federal regulatory scheme").

CONCLUSION

Petitioner respectfully requests that the Court grant the Petition.

Respectfully submitted,

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June 17, 1991

APPENDICES

APPENDIX A

Opinion of the United States Court of Appeals for the Second Circuit, Dated March 20, 1991

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 1023, 1131 August Term 1990

Argued February 6, 1991 Decided Mar 20 1991

Docket Nos. 90-5063, - 5073

IN RE: PRUDENTIAL LINES INC.,

Debtor.

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS

and

COLD SPRING SHIPPING, L.P.,

Appellees/Cross-Appellants,

v.

PSS STEAMSHIP COMPANY, INC.,

Appellant/Cross-Appellee.

Before:

TIMBERS, NEWMAN and ALTIMARI, *Circuit Judges.*

Appeal from an order entered September 28, 1990, in the Southern District of New York, Robert P. Patterson, *District Judge*, affirming an order of the bankruptcy court that permanently enjoined appellant from taking a worthless stock deduction with respect to its bankrupt subsidiary.

Affirmed.

Appendix A

W. Bruce Johnson, New York, N.Y. (Richard O'Toole, Joanne Wilson, and Battle Fowler, New York, N.Y., on the brief) *for appellant/cross-appellee PSS Steamship Company, Inc.*.

Max O. Truitt, Jr., Washington, D.C. (Wilmer, Cutler & Pickering, Washington, D.C.; Allan L. Gropper, and White & Case, New York, N.Y., on the brief) *for appellees/cross-appellants Cold Spring Shipping, L.P. and The Official Committee of Unsecured Creditors.*

TIMBERS, *Circuit Judge*:

Appellant/cross-appellee PSS Steamship Company, Inc. (PSS) appeals from an order entered September 28, 1990, in the Southern District of New York, Robert P. Patterson, *District Judge*, affirming an order of the bankruptcy court that permanently enjoined it from taking a worthless stock deduction on its 1988 federal income tax return with respect to its bankrupt subsidiary Prudential Liens, Inc. (PLI), since that would have adversely affected PLI's ability to carryforward its net operating loss (NOL) to offset future income.

On appeal, PSS contends that (1) the NOL generated by PLI was not property of PLI's estate within the meaning of § 541 of the Bankruptcy Code; and (2) the bankruptcy court erred in enjoining PSS from taking a worthless stock deduction on its 1988 federal income tax return as violative of the automatic stay. On cross-appeal, the Official Committee of Unsecured Creditors (Creditors' Committee) and Cold Spring Shipping, L.P. (Cold Spring) contend that the bankruptcy court erred in denying relief based on a violation of PSS' fiduciary duty to PLI.

Appendix A

Since we agree with Judge Patterson's excellent district court opinion and for the reasons that follow, we affirm the judgment of the district court.

I.

We shall summarize only those facts and prior proceedings believed necessary to an understanding of the issues raised on appeal.

At all times relevant to this appeal, PLI was a wholly owned subsidiary of PSS that provided United States flag shipping between ports in Europe and the Black Sea. Spyros S. Skouras, Sr. is chief executive officer and a director of PSS, and was Chairman and President of PLI until his resignation in November 1989. Spyros S. Skouras, Jr. was Vice President, General Manager, and a director of PLI. In addition, Skouras, Jr. has participated in the financial and tax affairs of PSS since 1986. In that capacity, he consults with PSS' tax counsel and accountants and relays information to his father.

PSS and PLI, along with two other affiliated entities have filed consolidated tax returns since 1976 pursuant to 26 U.S.C. § 1501 *et seq.* (1988). In 1988, these entities had a combined NOL of $75 million available to be offset against income. Of that amount, $74 million was attributable to PLI's pre-bankruptcy operations. NOLs are tax deductible and may be carried back and applied against income in previous years (carryback), or carried forward and applied against income in subsequent years (carryforward). 26 U.S.C. § 172 (1988).

On September 12, 1986, an involuntary petition for reorganization under Chapter 11 of the Bankruptcy Code was filed against PLI. Soon thereafter, PLI consented to an order

for relief. The Creditors' Committee was appointed pursuant to 11 U.S.C. § 1102 (1988) to represent the interests of PLI's unsecured creditors. Cold Spring purchased a participation interest in the unsecured claim of the United States Maritime Administration (MARAD).

In the summer of 1988, Skouras, Sr. and Skouras, Jr. began to formulate a plan for reorganization on behalf of PLI (the "PLI plan"). In connection with that plan, they prepared a term sheet dated August 4, 1988, which indicated that, under the PLI plan, the Skouras family would retain control of PLI and a NOL carryforward of $75 million would be available to offset future income of the reorganized company.

In February 1989, PSS was informed by tax counsel and by its accountants that it could take a $38.9 million worthless stock deduction in connection with its PLI stock on its 1988 federal income tax return. If PSS took that action, it would effectively eliminate the value of the NOL to PLI. Later that month, PLI filed a plan for reorganization with the bankruptcy court. Under that plan, Skouras, Jr. would retain a 75 percent interest in the reorganized company and serve as President. Skouras, Sr. would serve as Chairman of the reorganized company. The disclosure statement accompanying the PLI plan contemplated the availability of PLI's NOL to offset future income of the reorganized company.

In July 1989, PSS' accountants prepared a draft federal income tax return for 1988 that reflected a worthless stock deduction in connection with the PLI stock. The following month PLI filed an amended plan of reorganization. The disclosure statement accompanying the amended PLI plan still reflected the availability of the NOL carryforward to the reorganized company. It did not mention the possibility of PSS

taking a worthless stock deduction on its 1988 federal income tax return.

The PLI plan failed to win the support of the creditors. On September 11, 1989, the Creditors' Committee and Cold Spring filed a draft of a joint plan for reorganization (creditors' plan). That plan provided for new management of the reorganized company and provided for no distributions to the Skouras family. The PLI stock owned by the Skouras family was to be cancelled. Like PLI's plan, it also contemplated a carryforward of PLI's $74 million NOL. In an objection to this plan, filed September 19, 1989, PSS announced for the first time its intention to take a worthless stock deduction in the amount of $38.9 million in connection with its PLI stock on its 1988 tax return.

Skouras, Jr. attended three meetings with officials of MARAD, the unsecured creditor holding the largest single claim against PLI, to urge them to support the PLI plan and reject the creditors' plan. At one of these meetings, Skouras, Jr. provided MARAD with a written comparison of the two plans that described the NOL as preserved under the PLI plan and uncertain under the creditors' plan. Skouras, Jr. informed MARAD that PSS might take a worthless stock deduction on its 1988 tax return, which would limit any NOL available to a reorganized PLI.

On October 10, 1989, counsel for PLI met with counsel for the Creditors' Committee and Cold Spring. At that meeting counsel for PLI broached the subject of personal releases in favor of Skouras, Sr. and Skouras, Jr. in the event the creditors' plan was confirmed. The Creditors' Committee and Cold Spring sought assurances that PSS would not take the worthless stock deduction. PSS agreed, subject to revocation by written

notice, that it would not take the deduction while negotiations continued.

On November 6, 1989, after the negotiations failed, PSS informed Cold Spring by letter that it reserved the right to take the worthless stock deduction. On the following day Skouras, Jr. met with officials at MARAD and presented them with a copy of the letter. He told them that he did not know whether PSS actually intended to take the worthless stock deduction on its 1988 federal income tax return.

PLI rejected the request of the Creditors' Committee and Cold Spring to take steps to prevent PSS from taking the worthless stock deduction. Skouras, Sr. resigned from his positions with PLI, effective November 3, 1989, after PSS decided to take the worthless stock deduction on its 1988 tax return.

On November 13, 1989, the Creditors' Committee and Cold Spring commenced an adversary proceeding in the bankruptcy court seeking to have PSS preliminarily and permanently enjoined from taking the worthless stock deduction on its 1988 tax return. Count one of the complaint alleged that taking the worthless stock deduction on its 1988 tax return would amount to a breach of PSS' fiduciary duty to PLI. Count two alleged that PSS was using the threat of the worthless stock deduction only to interfere with the creditors' plan to reorganize PLI. Count three alleged that the NOL attributable to PLI was property of PLI's bankruptcy estate and that taking the worthless stock deduction would violate the automatic stay provision of the Bankruptcy Code.

On November 21, 1989, the bankruptcy court held a hearing on plaintiffs' motion for a preliminary injunction. At

the conclusion of the hearing, the bankruptcy court denied relief on counts one and two, holding that there was a legitimate business purpose for taking the worthless stock deduction and that the business judgment rule precluded further review of the propriety of that decision. On December 4, 1989, the bankruptcy court granted preliminary injunctive relief on count three. *Official Committee of Unsecured Creditors* v. *PSS S.S. Co., Inc. (In re Prudential Lines, Inc.)*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989). The bankruptcy court held that the NOL generated by PLI was property of PLI's bankruptcy estate and that the worthless stock deduction was an attempt to exercise control over that property in violation of the automatic stay. On December 19, 1989, the bankruptcy court permanently enjoined PSS from taking the worthless stock deduction on its 1988 tax return. *Official Committee of Unsecured Creditors* v. *PSS S.S. Co., Inc. (In re Prudential Lines, Inc.)*, 114 B.R. 27 (Bankr. S.D.N.Y. 1989). The creditors' plan for reorganization was confirmed on December 15, 1989. PSS has not yet filed its 1988 tax return.

PSS appealed from the decision of the bankruptcy court to the district court pursuant to 28 U.S.C. § 158(a) (1988). The Creditors' Committee and Cold Spring cross-appealed from the bankruptcy court's denial of the injunction on counts one and two. On September 28, 1990, the district court affirmed the judgment of the bankruptcy court. *Official Committee of Unsecured Creditors* v. *PSS S.S. Co., Inc. (In re Prudential Lines, Inc.)*, 119 B.R. 430 (S.D.N.Y. 1990). The district court denied the cross-appeal without prejudice.

This appeal followed.

Appendix A

II.

Initially, we set forth our standard of review. Our review of the district court order is plenary. *Gulf States Exploration Co.* v. *Manville Forest Prods. Corp. (In re Manville Forest Prods. Corp.)*, 896 F.2d 1384, 1388 (2 Cir. 1990); *Brown* v. *Pennsylvania State Employees Credit Union*, 851 F.2d 81, 84 (3 Cir. 1988). "This court exercises the same review over the district court's decision that the district court may exercise [over the bankruptcy court's decision]. " *Brown*, *supra*, 851 F.2d at 84. Accordingly, we will accept the bankruptcy court's findings of fact unless clearly erroneous. *In re Manville Forest Prods.*, *supra*, 896 F.2d at 1388; Bankr. Rule 8013. We review the bankruptcy court's legal conclusions *de novo*. *In re Manville Forest Prods.*, *supra*, 896 F.2d at 1388.

III.

With the foregoing in mind, we turn first to PSS' contention that the NOL attributable to PLI does not constitute property of PLI's bankruptcy estate within the meaning of § 541 of the Bankruptcy Code. PSS contends that the law of consolidated tax returns gives it, and not PLI, the right to use PLI's NOL to offset income. PSS contends that the right to the NOL carryforward is not PLI's property and cannot be considered property of PLI's estate. We disagree.

Our inquiry begins with the definition of property of the estate set forth in the Bankruptcy Code. Property of the estate encompasses "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1988). In construing this section, we are mindful that Congress intended § 541 to be interpreted broadly. *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 204

(1983). To facilitate reorganization, it is vital to include all the debtor's property in its bankruptcy estate. *Id.* at 203.

The nature and extent of the debtor's interest in property is determined by applicable non-bankruptcy law. *Crysen/Montenay Energy Co.* v. *Esselen Assocs., Inc. (In re Crysen/Montenay Energy Co.)*, 902 F.2d 1098, 1101 (2 Cir. 1990); *Sanyo Elec., Inc.* v. *Howard's Appliance Corp. (In re Howard's Appliance Corp.)*, 874 F.2d 88, 93 (2 Cir. 1989). Whether that interest is included in the property of the debtor's estate is determined by bankruptcy law. *In re Crysen/Montenay, supra*, 902 F.2d at 1101; *Coben* v. *Lebrun (In re Golden Plan of California, Inc.)*, 37 B.R. 167, 169 (Bankr. E.D. Cal. 1984).

(A)

We turn next to PSS' contention that PLI's status as an affiliated corporation filing a consolidated tax return abolished any interest it had in the right to use its NOL to offset its income. We disagree.

Affiliated corporations that meet certain criteria are entitled to file a consolidated tax return. 26 U.S.C. §§ 1501-04 (1988). Such returns are filed in the name of the "common parent", who acts as the agent for each subsidiary in the group and acts on behalf of the group in all matters related to tax liability for the consolidated group. 26 C.F.R. § 1.1502-77(a) (1990). A corporation must consent to the filing of a consolidated return on its behalf. 26 C.F.R. § 1.1502-75(b) (1990). Once consent is given, an affiliated group must obtain the permission of the IRS to deconsolidate. *Koscot Interplanetary, Inc.* v. *Glenn Turner Enters., Inc. (In re Koscot Interplanetary, Inc.)*, 76-1 U.S. Tax Cas. (CCH) ¶ 9442, at 84,188 (M.D. Fla. 1976); 26 C.F.R. § 1.1502-75(c) (1990). The filing of a bankruptcy petition by one of the members of

the group does not mandate a deconsolidation of the group. *In re Koscot*, *supra*, at 84,187.

"Those [corporations that] file consolidated returns are 'treated as a single entity for income tax purposes as if they were, in fact, one corporation.'" *Exxon Corp.* v. *United States*, 785 F.2d 277, 280 (Fed. Cir. 1986) (citation omitted); *see also International Tel. & Tel. Corp.* v. *United States*, 608 F.2d 462, 474 (Ct. Cl. 1979) ("[a] consolidated group of corporations filing a consolidated return is considered a single taxpayer"); *American Standard, Inc.* v. *United States*, 602 F.2d 256, 261 (Ct. Cl. 1979) ("purpose behind allowing corporations to file consolidated returns is to permit affiliated corporations, which may be separately incorporated for various business reasons, to be treated as a single entity for income tax purposes as if they were, in fact, one corporation"). Accordingly, NOLs of the affiliated corporations may be aggregated and applied against the consolidated income of the group. 26 C.F.R. § 1.1502-21 (1990).

In the instant case, PSS and PLI, along with two other affiliated corporations, have filed a consolidated tax return since 1976. Although the confirmation of the reorganization plan and the concomitant change in ownership of PLI will cause PLI's departure from the group, the corporations were still consolidated for tax purposes in the tax year in question. PSS contends that since PLI was a member of a group that filed a consolidated tax return, the common parent, not PLI, controlled the manner in which PLI's NOL would be applied against income of the group members. PSS contends, therefore, that the right to the NOL carryforward was not PLI's property at the commencement of the bankruptcy case.

In support of its position, PSS relies on a series of cases that

stand for the proposition that one member of an affiliated group does not have to compensate another member for tax benefits accruing to it through the use of the other member's NOL. *E.g.*, *Western Pac. R.R. Corp.* v. *Western Pac. R.R. Co.*, 197 F.2d 994, 1004 (9 Cir. 1951), *rev'd on other grounds*, 345 U.S. 247 (1953); *In re Coral Petroleum, Inc.*, 60 B.R. 377, 389 (Bankr. S.D. Tex. 1986); *In re All Products Co.*, 32 B.R. 811, 814 (Bankr. E.D. Mich. 1983); *M & M Transp. Co.* v. *U.S. Indus., Inc.*, 416 F. Supp. 865, 869 (S.D.N.Y. 1976); *Meyerson* v. *El Paso Natural Gas Co.*, 246 A.2d 789, 791-94 (Del. Ch. 1967); *Case* v. *New York Cent. R.R. Co.*, 15 N.Y.2d 150, 158, 204 N.E.2d 643, 647, 256 N.Y.S.2d 607, 612 (1965). That reliance is misplaced.

The above cases were decided under fiduciary duty and contract standards. *Western Pac*, *supra*, 197 F.2d at 999 (bankrupt subsidiary did not breach fiduciary duty by using parent's NOL to offset its income); *In re Coral Petroleum, supra*, 60 B.R. at 390-91 (corporate debtor did not have fiduciary duty to compensate subsidiary for use of its NOL to offset income of other subsidiaries on consolidated return and was not unjustly enriched by that action); *In re All Prods. Co.*, *supra*, 32 B.R. at 813-15 (bankrupt subsidiary could not reduce parent's claim by amount that parent's tax liability was diminished through use of subsidiary's NOL on consolidated return); *M & M Transp. Co.*, *supra*, 416 F. Supp. at 869 (former subsidiary seeking compensation from former parent for use of NOL on consolidated return that resulted in tax refund); *Meyerson, supra*, 262 A.2d at 791-94 (parent did not breach fiduciary duty by using subsidiary's NOL to offset its income on consolidated return); *Case, supra*, 15 N.Y.2d at 154-55, 204 N.E.2d at 644-45, 256 N.Y.S.2d at 608-09 (action to rescind agreement among affiliated corporations regarding the allocation of federal tax liability on consolidated return). As such they are more

appropriate to the issues raised by the cross-appeal. Moreover, although some of these cases involved bankrupt corporations, none purported to determine whether the NOL attributable to the bankrupt corporation was property of that corporation's bankruptcy estate.

Only *In re All Prods. Co.* involved a parent corporation's use of its bankrupt subsidiary's NOL to offset its income. In that case, the tax savings occurred prior to the filing of the bankruptcy petition, 32 B.R. at 813, and the court did not consider the issue of whether the NOL attributable to the debtor at the time of the filing of the bankruptcy petition was property of its bankruptcy estate. Moreover, the court in that case found implied consent on the part of the subsidiary to the use of its NOL to offset the parent's income. *Id.* at 814-15. It is not disputed that "where there is an explicit agreement, or where an agreement can fairly be implied, as a matter of state corporation law the parties are free to adjust among themselves the ultimate tax liability." *Western Dealer Management, Inc.*, v. *England* (*In re Bob Richards Chrysler-Plymouth Corp., Inc.*), 473 F.2d 262, 264 (9 Cir.), *cert. denied*, 412 U.S. 919 (1973) (footnotes omitted). However, "consent[] to the filing of a consolidated tax return . . . cannot be construed to include the transfer of a valuable asset without further consideration." *In re Bob Richards*, *supra*, 473 F.2d at 264. There was no explicit agreement between PSS and PLI as to the allocation of PLI's NOL. We discern no such implied agreement.

The fact that a subsidiary's NOL ultimately may be used to offset another corporation's income does not mean that the subsidiary loses any interest in its NOL. The common parent acts as an agent on behalf of all the members of the consolidated group "for the convenience and protection of [the] IRS only." *Jump* v. *Manchester Life & Casualty Management*

Corp., 579 F.2d 449, 452 (8 Cir. 1978); *accord*, *In re Bob Richards*, *supra*, 473 F.2d at 265. The corporations retain their separate identities and the property interests of the subsidiaries are not absorbed by the common parent. *Wolter Constr. Co., Inc.* v. *Commissioner*, 634 F.2d 1029, 1038 (6 Cir. 1980). It follows that a corporation does not lose any interest it had in the right to use its NOL to offset income because of its status in a group of affiliated corporations that file a consolidated tax return. *E.g.*, 26 C.F.R. § 1.1502-79(a)(1)(ii) (1990) (upon deconsolidation any remaining NOL attributable to a corporation is available to offset income on its separate tax returns); *see also In re Bob Richards*, *supra*, 473 F.2d at 265 ("[a]llowing the parent to keep any refunds arising solely from a subsidiary's losses simply because the parent and subsidiary chose a procedural device to facilitate their income tax reporting unjustly enriches the parent").

We hold that at the commencement of the bankruptcy case against it, PLI had an interest in the $74 million NOL attributable to its pre-bankruptcy operation.

(B)

This brings us to the question whether PLI's interest in the right to carryforward its $74 million NOL to offset future income is property of the estate within the meaning of § 541. We hold that it is.

In *Segal* v. *Rochelle*, 382 U.S. 375 (1966) (Harlan, J.), the Supreme Court, construing § 541's predecessor, considered whether a NOL carryback that resulted in a tax refund to an individual debtor was property of that debtor's estate. The Court held that a NOL carryback was property of an individual debtor's estate.

Id. at 380. Recognizing the "conceptual[] as well as practical[]" differences between carrybacks and carryforwards, the Court declined to decide the issue of whether NOL carryforwards were also property of the estate. *Id.* at 381. It expressed concern that including NOL carryforwards as property of the estate of an individual debtor could endanger the fresh start policy of the Bankruptcy Act by forcing the estate to remain open for a long period. *Id.*

The legislative history of § 541 demonstrates that Congress agreed with the result reached by the *Segal* Court.

> "[T]he estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified in [the predecessor statute to § 541] . . . . The result of *Segal* v. *Rochelle*, 382 U.S. 375 (1966), is followed, and the right to a refund is property of the estate."

S. Rep. No. 95-989, 95th Cong. 2d Sess. 82, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5868; H.R. Rep. No. 95-595, 95th Cong. 1st Sess. 367, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6323 (footnote omitted).

Courts, applying *Segal*, have held that a subsidiary is entitled to a tax refund due to its NOL carryback to the extent that it offsets its own income. *E.g.*, *Jump*, *supra*, 579 F.2d at 452; *In re Bob Richards*, *supra*, 473 F.2d at 264; *In re Revco D.S., Inc.*, 111 B.R. 631, 639 (Bankr. N.D. Ohio 1990).

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Courts considering whether NOL carryforwards constitute property of the estate have reached varying conclusions in varying contexts. *Compare Jump*, *supra*, 579 F.2d at 453 ("the right to use its net operating loss to gain carryover tax advantage was not an asset of [a liquidating subsidiary] because its value was conditioned on the existence of future income potential of [the subsidiary]") *and Davis* v. *Commissioner*, 69 T.C. 814, 827 (1978) ("net operating loss carryover cannot constitute property" of an individual debtor's estate) *with In re Beery*, 116 B.R. 808, 810 (D. Kan. 1990) right to use NOL carryforward is property of debtor's estate).

PSS contends that *Segal* does not control the instant case since it involved a NOL carryback rather than a NOL carryforward, and an individual rather than a corporate debtor filing a consolidated return. Those distinctions do not require a contrary result here.

Carryforwards differ in nature from carrybacks. Carrybacks result in the right to a tax refund of a definite amount. Carryforwards, by contrast, are speculative since their value depends on the availability of future income against which to apply them. The speculative nature of carryforwards does not place them outside the definition of property of the estate. "[T]he term 'property' has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed." *Segal*, *supra*, 382 U.S. at 379; *see also* H.R. Rep. No. 95-595, 95th Cong. 2d Sess. 175-76, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6136 (property of the estate "includes all interest, such as . . . contingent interests and future interests, whether or not transferable by the debtor"). The fact that the right to a NOL carryforward is intangible and has not yet been reduced to a tax refund also does not exclude it from the

definition of property of the estate. *In re Golden Plan*, *supra*, 37 B.R. at 169. In short, interests whose value is speculative and interests that involve intangible rights that are subject to regulation may be included as property of the estate. *E.g.*, *Neuton* v. *Danning* (*In re Neuton*), 922 F.2d 1379, 1382-83 (9 Cir. 1990) (interest in trust contingent on survivorship is property of the estate); *Tringali* v. *Hathaway Mach. Co.*, 796 F.2d 553, 560 (1 Cir. 1986) (liability insurance policy is property of the estate); *Beker Indus. Corp.* v. *Florida Land & Water Adjudicatory Comm'n* (*In re Beker Indus. Corp.*), 57 B.R. 611, 622 (Bankr. S.D.N.Y. 1986) (right to truck products from mine is property of estate); *In re Golden Plan*, *supra*, 37 B.R. at 169 (corporate name is property of the estate). Thus, the nature of the interest involved in the instant case does not compel a conclusion that it is not property of the estate.

As the *Segal* Court observed, the main hurdle to including NOL carryforwards as property of the estate is the detrimental impact it could have on the fresh start policy that is promoted by the Bankruptcy Code. *Segal*, *supra*, 382 U.S. at 381. Subsequent legislation has ameliorated that concern with respect to individual debtors and suggests that Congress intended that NOL carryforwards be included in the property of the estate of individual as well as corporate debtors.

Congress provided for the tax treatment of debtors and their bankruptcy estates in § 346 of the Bankruptcy Code. With respect to individual debtors, Congress provided that the income to their estates could be taxed separately from the income to the individual debtor. 11 U.S.C. § 346(b)(1) (1988). Congress also provided that the estate succeeds to the tax attributes of individual debtors including "any loss carryover." 11 U.S.C. § 346(i)(1)(C) (1988). To address the *Segal* Court's concern that including carryforwards as property

of the estate would jeopardize the fresh start policy, Congress provided that unutilized tax attributes revert to the debtor at the conclusion of the case. 11 U.S.C. § 346(i)(2) (1988). Section 346(i) seems to contemplate that NOL carryforwards, as well as carrybacks, become property of an individual debtor's bankruptcy estate. Other subsections contemplate use of NOL carryforwards by a corporate debtor. *E.g.*, 11 U.S.C. § 346(h) (1988) (determination of periods in which debtor may use NOL carryover); 346(j)(3) (NOL carryover of individual or corporate debtor is reduced by the amount of debt forgiven or discharged).

We do not read § 346(i) as applying to corporate debtors. *E.g, Maritime Asbestosis Legal Clinic* v. *LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 920 F.2d 183, 187 (2 Cir. 1990) (section permitting individual debtors to recover sanctions for willful violations of automatic stay cannot be read to apply to corporate debtors). Congress' failure to include corporate debtors in that provision does not imply, however that Congress meant to treat NOL carryforwards of corporate debtors differently than those of individual debtors. Since the bankruptcy estate of a corporate debtor is not a separate entity for tax purposes, 11 U.S.C. § 346(c)(1) (1988), there was no need for Congress to provide that carryovers are transferred to the estate and then back to the corporate debtor at the conclusion of the case.

Corporations attempting to reorganize under Chapter 11 are ongoing concerns that generate income used to pay pre-petition creditors. *Whiting Pools, supra*, 462 U.S. at 203. Furthermore, a liquidating corporation's debts are not discharged in bankruptcy. 11 U.S.C. § 727(a)(1) (1988). The fresh start policy, therefore, does not apply to corporate debtors. *City of New York* v. *Quanta Resources Corp.* (*In re*

Quanta Resources Corp.), 739 F.2d 912, 915 n.7 (3 Cir. 1984), *aff'd*, 474 U.S. 494 (1986); *In re Blanton*, 105 B.R. 811, 824 (Bankr. W.D. Tex. 1989); *see also* Note, *Bankruptcy and the Union's Bargain: Equitable Treatment of Collective Bargaining Agreements*, 39 Stan. L. Rev. 1015, 1025 n.67 (1987) ("the fresh start policy does not apply to corporation"). Thus, the concern that the *Segal* Court expressed does not apply to a situation involving a corporate debtor. When the fresh start policy is not implicated, the argument for including NOL carryforwards as property of the bankruptcy estate is strengthened. *Compare In re Beery*, *supra*, 116 B.R. at 810 (NOL carryforward is property of the estate; fresh start policy not implicated since individual not entitled to discharge because of misconduct) *with Davis*, *supra*, 69 T.C. at 827-28 (relying on detriment to fresh start policy in case where NOL carryforward had value only to debtor, but not to estate, to conclude that it was not property of the estate).

Finally, in determining the scope of § 541 we must consider the purposes animating the Bankruptcy Code. *Kokoszka* v. *Belford*, 417 U.S. 642, 645 (1974); *Lines* v. *Frederick*, 400 U.S. 18, 19 (1970); *Segal*, *supra*, 382 U.S. at 379. Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to "bring anything of value that the debtors have into the estate." H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 176, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6136. Moreover, "[a] paramount and important goal of Chapter 11 is the rehabilitation of the debtor by offering breathing space and an opportunity to rehabilitate its business and eventually generate revenue." *International Ass'n of Machinists and Aerospace Workers* v. *Eastern Air Lines, Inc.*, 121 B.R. 428, 433 (S.D.N.Y. 1990), *aff'd*, 923 F.2d 26 (2 Cir. 1991). Including the right to a NOL carryforward as property of PLI's bankruptcy estate furthers the purpose of

facilitating the reorganization of PLI. The fact that both plans for reorganization contemplated its availability to the reorganized company suggests that PLI's $74 million NOL was a valuable asset of PLI.

We hold that the right to a carryforward attributable to its $74 million NOL was property of PLI's bankruptcy estate.

IV.

We turn now to PSS' contention that the bankruptcy court erred in enjoining it from taking a worthless stock deduction on its 1988 tax return. We hold that the injunction entered by the bankruptcy court was proper.

The commencement of a bankruptcy case operates to stay "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3) (1988). "The reach of the automatic stay is limited by its purposes." *Price & Pierce Int'l, Inc.* v. *Spicers Int'l Paper Sales, Inc.*, 50 B.R. 25, 26 (S.D.N.Y. 1985); *accord Rett White Motor Sales Co.* v. *Wells Fargo Bank*, 99 B.R. 12, 13 (N.D. Cal. 1989). One of the principal proposes of the automatic stay is to preserve the property of the debtor's estate for the benefit of all the creditors. *Holtkamp* v. *Littlefield* (*In re Holtkamp*), 669 F.2d 505, 508 (7 Cir. 1982); *In re Fed. Press Co.*, 117 B.R. 942, 946 (Bankr. N.D. Ind. 1989); *In re Gatke Corp.*, 117 B.R. 406, 408 (Bankr. N.D. Ind. 1989).

In the instant case, if PSS were allowed to take a worthless stock deduction on its 1988 tax return, it would effectively eliminate the value of the NOL carryforward to PLI and thus have an adverse impact on PLI's reorganization. The use of

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NOLs as tax deductions following a change in ownership of a corporation is governed by 26 U.S.C. § 382 (1988). The amount of the deduction is limited to "the value of the old loss corporation" multiplied by "the long-term tax-exempt rate". 26 U.S.C. § 382(b) (1988). A change of ownership is deemed to have occurred if a greater than 50 percent shareholder takes a worthless stock deduction, but retains the stock at the end of the taxable year. 26 U.S.C. § 382(g)(4)(D) (1988). The value of the old loss corporation is generally measured by the value of the stock immediately prior to the ownership change. 26 U.S.C. § 382(e)(1) (1988). Since PSS owned 100 percent of the stock of PLI, if it declared that stock to be worthless and retained ownership of the stock at the end of the taxable year, the value of the PLI stock would be zero for the purposes of § 382. Accordingly, the "new" corporation would not be entitled to any NOL carryforward.

In *48th St. Steakhouse, Inc.* v. *Rockefeller Group, Inc.* (*In re 48th St. Steakhouse, Inc.*), 835 F.2d 427 (2 Cir. 1987), *cert. denied*, 485 U.S. 1035 (1988), we held that a landlord's attempt to terminate its lease with a non-debtor was subject to the automatic stay since it would have had the legal effect of terminating the debtor's sublease. *Id.* at 431. Despite the fact that the landlord's action was not directed specifically at the debtor, we held that

> "where a non-debtor's interest is intertwined . . . with that of a bankrupt debtor . . . [and an] action taken against the non-bankrupt party would inevitably have an adverse impact on property of the bankrupt estate, then such action should be barred by the automatic stay."

Id. Similarly, where a non-debtor's action with respect to an

interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay.

In the instant case, PSS' interest in its worthless stock deduction is intertwined with PLI's NOL. If PSS were permitted to take a worthless stock deduction ont its 1988 tax return, it would have an adverse impact on PLI's ability to carryforward its NOL. Accordingly, despite the fact that PSS' action is not directed specifically at PLI, it is barred by the automatic stay as an attempt to exercise control over property of estate.

The permanent injunction entered by the bankruptcy court also is supported by its equitable powers pursuant to § 105(a). That provision grants the bankruptcy court power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provision of [the Bankruptcy Code]." 11 U.S.C. § 105(a) (1988). "This provision has been construed liberally to enjoin [actions] that might impede the reorganization process." *MacArthur Co.* v. *Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89, 93 (2 Cir.), *cert. denied*, 488 U.S. 868 (1988). In light of the testimony of the parties that the $74 million NOL was a valuable asset of PLI we will not disturb the bankruptcy court's finding that elimination of the right to apply its NOL to offset income on future tax returns would impede PLI's reorganization.

Finally, we consider PSS' claim that the bankruptcy court was without jurisdiction to enter the injunction. PSS relies for this proposition on a series of cases that held that § 505(a)(1) of the Bankruptcy Code, which gives the bankruptcy court the power to "determine the amount or legality of any tax", does not confer jurisdiction on the bankruptcy court to adjudicate the

tax liability of non-debtors. *E.g.*, *American Principals Leasing Corp.* v. *United States*, 904 F.2d 477, 480-81 (9 Cir. 1990); *Brandt-Airflex Corp.* v. *Long Island Trust Co., N.A.* (*In re Brandt-Airflex Corp.*), 843 F.2d 90, 95-96 (2 Cir. 1988); *In re Vermont fiberglass, Inc.*, 88 B.R. 41, 43-44 (D. Vt. 1988).

In the instant case, the bankruptcy court did not determine the amount or legality of PSS' tax liability. The bankruptcy court's power was based on its jurisdiction over property of the estate. *In re Johns-Manville Corp.*, *supra*, 837 F.2d at 91. Having properly exercised jurisdiction, the bankruptcy court may enter an injunction that affects derivative rights of a non-debtor. *Id.* 92.93.

V.

Since we hold that the bankruptcy court's injunction was justified based on count three of the complaint, we find it neither necessary nor appropriate to consider the issues raised by the cross-appeal of the Creditors' Committee and Cold Spring.

VI.

To summarize:

We hold that the right to carryforward a tax deduction due to the NOL attributable to PLI's pre-bankruptcy operation was property of PLI's bankruptcy estate. We further hold that PSS' attempt to take a worthless stock deduction with respect to its PLI stock that would effectively destroy the value of the NOL carryforward generated by PLI was properly enjoined by the bankruptcy court. We do not consider the issues raised by the cross-appeal.

Affirmed.

APPENDIX B

Opinion and Decision of the United States District Court for the Southern District of New York, Dated September 28, 1990

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

90 Civ. 1262 (RPP)
90 Civ. 1263 (RPP)
(Cross-Appeal)

In Re:

PRUDENTIAL LINES, INC.,

Debtor.

Appealing Adversary Proceeding No. 89-6430A

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS and COLD SPRING SHIPPING, L.P.,

Plaintiffs-Appellees,

-against-

PSS STEAMSHIP COMPANY, INC.,

Defendant-Appellant.

OPINION AND ORDER

Appendix B

APPEARANCES

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Appendix B

ROBERT P. PATTERSON, JR., U.S.D.J.

This matter is before the Court on appeal from the December 19, 1989, decision of the United States Bankruptcy Court for the Southern District of New York (Buschman, J.) permanently enjoining defendant PSS Steamship Company ("PSS") under the automatic stay provision of 11 U.S.C. § 362(a)(3) from claiming a worthless stock deduction under the Internal Revenue Code for its 1988 consolidated tax return. For the reasons set forth below, the decision of the Bankruptcy Court is affirmed.[1]

BACKGROUND

An involuntary Chapter 11 petition was filed against the debtor Prudential Lines, Inc. ("PLI"), in the Bankruptcy Court on September 12, 1986. PLI continued to operate its business as debtor-in-possession pending reorganization. On October 2, 1989, Cold Spring Shipping ("Cold Spring") and The Official Committee of Unsecured Creditors ("The Official Committee") filed a Second Amended Joint Plan of Reorganization ("the Plan") with the bankruptcy court. A confirmation hearing on the proposed Plan was scheduled at the time this action was commenced.

The Plan basically provided that unsecured creditors were to receive $10 million in notes due five years after issuance and bearing 12.5% interest. Payment on the notes was to be funded at least in part by cash flow generated by continued

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[1] Because the Court affirms the Bankruptcy Court's application of § 362, the Court denies without prejudice the cross-appeal of The Official Committee and Cold Spring alleging errors by the Bankruptcy Court in applying state law.

operation of PLI's business. Cash flow was to be made available for this purpose by using PLI's $74 million in net operating losses ("NOL") as a carryforward in 1989 to reduce tax liabilities on the cash flow income. The Plan also provided for cancellation of certain outstanding stock of PLI.

In December 1987, Congress enacted a new §382(g)(4)(D) of the Internal Revenue Code, 26 U.S.C. §382(g)(4)(D), which eliminates most or all of a subsidiary's use of NOL in the year following the year in which its parent takes a worthless stock deduction for the subsidiary's stock. Defendant PSS is a parent holding company which owns all of the outstanding stock of the Chapter 11 debtor PLI subject to cancellation under the Plan. PSS sought to claim a worthless stock deduction for the year 1988 thereby eliminating PLI's NOL as a carryforward in 1989 should the Plan have been confirmed in that year.[2]

Plaintiffs thus moved the Bankruptcy Court on November 13, 1989, for preliminary injunctive relief preventing PSS from claiming a worthless stock deduction with respect to the PLI stock in any tax year prior to the year in which confirmation of a reorganization plan for PLI issued. The Court

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[2] Members of the extended Skouras family control PSS through a series of holding companies and trusts. Spyros Skouras was chief executive officer and director of both PLI and PSS until he resigned in November 1989 from his positions at PLI. His son, Spyros Skouras, Jr., remains as an officer and director of the debtor PLI. The Reorganization Plan proposed *inte alia* removal of Spyros Skouras from management of PLI and cancellation of the PLI stock held by PSS. An earlier reorganization plan contemplating the continuation of Skouras management and control of PLI and utilization of the NOL as a carryforward in 1989 was approved by the debtor but not the creditors. Only after creditors formulated the present reorganization plan did PSS claim the right to take a worthless stock deduction for the year 1988.

granted the relief on the grounds that the right to carry forward a NOL was exclusive "property" of the bankruptcy estate under 11 U.S.C. §541(a) and that a parent company's claiming a worthless stock deduction of its debtor-subsidiary was an act seeking "to exercise control over property of the estate" in violation of the automatic stay imposed by 11 U.S.C. §362(a)(3).

The Plan was confirmed by order dated December 15, 1989. Appellees were then successful in a motion to convert the December 4 preliminary injunction into a permanent injunction on December 19, 1989. It is that decision of the Bankruptcy Court from which appeal is taken.

DECISION BELOW

The Bankruptcy Court adjudged the two issues presented to be "issues of first impression" in this district. Slip Op. at 9. The court relied on *Segal v. Rochelle*, 382 U.S. 375 (1966), which held that potential claims for NOL carryback refunds due to pre-bankruptcy losses are property of the bankruptcy estate. Congress endorsed the result in *Segal* when it amended the Bankruptcy Code. H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 367, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6323. Applying *Segal*, the court saw no reason to distinguish NOL carryovers from NOL carrybacks with respect to a corporate debtor. Because the carryover was "property" of PLI's bankruptcy estate, the Bankruptcy Court held that the statutory scheme underlying Chapter 11 of the Bankruptcy Code would be defeated if PSS were permitted, post-confirmation, to claim a worthless stock deduction for 1988, eliminating PLI's NOL carryover as of 1988. The Bankruptcy Court enjoined PSS from taking the deduction for 1988 since

the effect would relate back to a period covered by the automatic stay of 11 U.S.C. §362.

DISCUSSION

Appellants seek to distinguish *Segal* on the grounds that NOL carrybacks only become property under §541(a) when they have ripened into right to a refund from the I.R.S. at the time of the bankruptcy filing. This Court disagrees. The legislative history of §541(a) makes clear that the definition of property "will bring anything of value that the debtors have into the estate," H.R. Rep., *supra*, at 176, including "tangible and intangible property . . . whether or not transferrable by the debtor." *Id.* at 175-76. The right to use a NOL carryover to obtain favorable tax treatment is of value to an ongoing business and is certainly something of value to the debtor as part of a reorganization plan. When creditors go unpaid due to the very losses giving rise to the NOL, they ought to be able to realize the value of a NOL carryover as property of the bankruptcy estate upon reorganization. The tax cases cited by appellants are inapposite.

Similarly, the Bankruptcy Court did not err as a matter of law in ruling that PSS's claiming a worthless stock deduction would violate the automatic stay imposed by 11 U.S.C. §362. The scope of protection afforded by the automatic stay provision is broad, *see In re R.S. Pinellas Motel Partnership*, 2 B.R. 113, 118 (Bankr. M.N. Fla. 1979), and it bars any action which "would inevitably have an adverse impact on the property of the bankruptcy estate. *In re 48th Street Steakhouse, Inc.*, 835 F.2d 427, 431 (2d Cir. 1987), *cert. denied*, 485 U.S. 1035 (1988).

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Appellant opposes the Bankruptcy Court ruling under §362 by arguing that since a NOL is not property of the estate, a parent corporation's claiming a worthless stock deduction which thereby eliminates NOLs of its subsidiary is not an act to "exercise control over property of the estate" under §362. This argument is without merit given this Court's ruling on the property issue.

PSS also argues that the broad authorization of relief "necessary or appropriate to carry out the provisions of this title" in 11 U.S.C. §105 does not permit extension of §362 relief beyond the date of confirmation of a reorganization plan. However, the Bankruptcy Court has authority to permanently enjoin actions by third parties which "would adversely affect property of the estate and would interfere with reorganization." *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 93 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). The permissible scope of relief implementing §362(a)(3) is guided by the provision's underlying congressional purposes of preventing dismemberment of the estate and assuring orderly distribution. *See* H.R. Rep., *supra*, at 341. PSS remains free to claim the worthless stock deduction for years after 1988.

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For the foregoing reasons, the December 19, 1989, decision of the Bankruptcy Court issuing a permanent injunction is affirmed.

SO ORDERED.

Dated: New York, New York
September 27, 1990

/s/Robert P. Patterson, Jr.
Robert P. Patterson, Jr.
U.S.D.J.

APPENDIX C

Opinion and Decision of the United States Bankruptcy Court for the Southern District of New York, Dated December 19, 1989

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Case No. 86B-11773 (HCB)

In Re:

PRUDENTIAL LINES, INC.,

Debtor.

Adv. No. 89-6430A

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS
and
COLD SPRING SHIPPING, L.P.,

Plaintiffs,

-against-

PSS STEAMSHIP COMPANY, INC.,

Defendant.

DECISION

BEFORE: Honorable Howard C. Buschman III
United States Bankruptcy Judge

Appendix C

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Before the Court are the respective submissions of the parties regarding the judgment to be entered implementing this Court's decision of December 4, 1989, slip op. Adv. No. 89-6430A (Bankr. S.D.N.Y. Dec. 4, 1989) ("Decision") and a decision of December 14, 1989, consolidating, pursuant to FED. R. CIV. P. Rule 65(a)(2), the hearing held on the motion for a preliminary injunction with the trial on the merits. The issue to be decided is whether the Court should enter a permanent injunction barring defendant PSS Steamship

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Company ("PSS") from claiming a worthless stock deduction under the Internal Revenue Code for 1988 or any other tax year ending prior to the effective date of the confirmation of a reorganization plan. The claiming of the deduction for any such year would have the effect of eliminating net operating loss ("NOL") carryover rights of the debtor, Prudential Lines, Inc. ("PLI"). *See*, Decision at 22-23, note 18.

I

Familiarity with this Court's decision of December 4, 1989 is assumed. There it was held that the claiming of a worthless stock deduction by a sole shareholder of a debtor-in-possession, having the consequence of eliminating a corporate debtor's NOL carryover rights, was barred by the automatic stay contained in §362(a)(3) of Title 11 of the United States Code (the "Code") in that it was an exercise of control over estate property. Decision at 9-26.

Shortly after that decision, plaintiffs proceeded to confirmation of their proposed plan. No objection to confirmation was received and the plan was confirmed by order dated December 15, 1989. PSS currently owns 100% of the issued and outstanding stock of PLI. The plan provides that, on its effective date, all stock previously issued by PLI will be cancelled and that property of the estate will be returned to PLI.

Because the permanent injunction requested by plaintiffs would bar PSS from claiming a worthless stock deduction after confirmation, PSS asserts that such an injunction is impermissible. It observes that §362(c)(1) of the Code provides that "the stay of an act against property of the estate . . . continues until such property is no longer property of the

estate" and that §1141(b) of the Code removes all property from the estate on confirmation or at the time provided in the plan and vests it in the debtor or, if the plan so provides, in other entities. Thus, PSS argues, the automatic stay no longer applies and it cannot be enjoined from violating the stay. In effect, PSS argues that, on confirmation, the branch of the complaint asserting a violation of the automatic stay became moot because the stay cannot be extended after confirmation.

These assertions, however, ignore that the relief plaintiffs seek is not an extension of the automatic stay to bar acts having effect only after confirmation. They seek only to bar the claiming of a deduction for tax years ending prior to confirmation and thus retroactively eliminating PLI's NOL carryover rights protected by the automatic stay. They assert that not to enjoin the claiming of the deduction reduces the automatic stay to a nullity.

II

The principal purpose of the automatic stay of acts against property of the estate, set forth in §362(a)(3) of the Code and elsewhere in §362(a), is to preserve that property for distribution or use in reorganization of the debtor. Decision at 25; *Pension Benefit Guaranty Corp. v. The LTV Corporation (In re Chateaugay Corp.)* 87 B.R. 779 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 1008 (2d Cir.), *cert. granted on another issue*, ___ U.S. ___, 110 S.Ct. 321, ___ L.Ed.2d ___, 58 U.S.L.W. 3288 (Oct. 30, 1989) (No. 89-390); *Continental Air Lines, Inc. v. Hillblom*, 61 B.R. 758 (S.D. Tex. 1986). On confirmation of a reorganization plan, that purpose is accomplished to the degree that property so preserved is to be distributed pursuant to the plan or to be utilized by the reorganized debtor in

carrying out the plan free of pre-bankruptcy claims and interests except as the plan provides.

This concept is expressed in §1141(c) of the Code. That section generally provides that, unless the plan or confirmation order provides differently, "the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders and of general partners of the debtor." Section 1141(c) thus decrees that estate property preserved during the course of the proceeding remains so preserved from attack by parties in interest to the bankruptcy case.[1]

These sections assist in implementing the general purposes of a Chapter 11 case: to preserve estate property prior to confirmation thereby enabling all parties in interest to make intelligent decisions as to, *inter alia*, whether the debtor should be liquidated or reorganized, the form of reorganization, and appropriate distributions to creditors, and to enable the plan to work with the debtor's property free from prior claims of

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[1] The term "creditors" is defined to consist of holders of pre-petition claims, 11 U.S.C. §101(9), and the reference to equity security holders means shareholders of the debtor, 11 U.S.C. §101(16), even though the rights and interests of shareholders could be terminated under §1141(d)(1)(B) of the Code. Section 1141(c) apparently does not embrace administrative creditors, *i.e.*, those creditors whose claims arose post-petition and prior to confirmation, for their claims are to be paid in full on the effective date of the plan. *See*, 11 U.S.C. §1129(a)(9). Nor does it embrace post-confirmation creditors, whose dealings with the debtor after confirmation, gave rise to post-confirmation claims. Only pre-petition and administrative claims are resolved in the bankruptcy process. *E.g.*, *In re Herron*, 60 B.R. 82 (Bankr. W.D. La. 1986); *In re Korgan*, 52 B.R. 557 (Bankr. D. Or. 1985). Upon confirmation, the reorganized debtor returns to the commercial world without protection from post-petition creditors. *In re Pan American School of Travel Inc.*, 47 B.R. 242, 244 (Bankr. S.D.N.Y. 1985).

creditors and interests of stockholders except as provided in the plan.

This statutory scheme would be defeated were the protection of estate property afforded by the automatic stay prior to confirmation of a plan subject to being retroactively undermined by a post-confirmation act relating back to the period when the automatic stay applied. The property that a debtor would distribute to creditors or use as a reorganized entity will have turned to sand. The expectations of parties in interest as to return under a plan, reasonably based on preservation of property of the estate afforded by the automatic stay, will have been dashed. The underpinnings of the plan process, based on decisions made with respect to that property and its value, will have been annulled. The automatic stay of acts against property of the estate will have been subverted.

Totally different are post-confirmation acts against property by post-confirmation creditors. Section 1141(d) does not protect the debtor's property from them. *See*, note 1 *supra*. But this is not a case where a post-confirmation creditor of a debtor seeks to obtain a judgment lien or where a secured creditor, allowed by a plan to retain its lien on debtor property, seeks post-confirmation, to foreclose its lien upon the debtor's post-confirmation default. In those instances, the acts are not retroactive. They have effect only post-confirmation when the judgment is entered or foreclosure ordered.[2]

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[2] Nor is this a case, like *Inforex Inc. v. Burridge (In re Inforex, Inc.)*, 26 B.R. 515 (Bankr. D. Mass. 1983), where purchasers and sellers of the debtor's securities were permitted to assert causes of action under the securities laws against the debtor's officers and directors based on their conduct before and during a Chapter 11 case. The court held that termination of shareholders' interests by virtue of confirmation did not

(continued...)

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Here, because PSS threatens to claim a worthless stock deduction on its 1988 tax return, an ownership change under §382 of the Internal Revenue Code, 26 U.S.C. §382 (1988), would be deemed to have occurred as of December 31, 1988, the end of PSS 1988 tax year, since PSS still held stock in PLI. 26 U.S.C. §382(g)(4)(d); *see*, Decision at 22-3, note 18. If PSS is permitted to do so, PLI's NOL carryovers will be eliminated as of that date--a date well within the period covered by the automatic stay. Since, as we have held, the automatic stay bars the termination of a corporate debtor's NOL carryover rights by the claiming of a worthless stock deduction, the claiming of such a deduction post-confirmation must be enjoined since its effect relates back to a period covered by the automatic stay. Any other result would destroy the preservative purpose of the automatic stay, interfere with the debtor's reorganization, and abuse the statutory scheme.

Fairly analogous is *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988). There the bankruptcy court, during the course of the bankruptcy case, had approved settlements between the debtor and some of its insurance carriers whose policies were property of the estate, permanently enjoined third parties, including co-insureds, from proceeding against the policies and limited them to proceeding against the settlement fund. On appeal, the Second Circuit upheld the injunction. It ruled that the rights of a co-insured against the policy were completely derivative of the debtor's

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[2](...continued)
preclude a purchaser or seller of stock from maintaining a cause of action against non-debtors for having been damaged in a securities transaction. 26 B.R. at 520. That cause of action, unlike the claiming of the deduction here, was not barred by the automatic stay. Nor was recovery sought from the debtor's property.

rights as the primary insured, 837 F.2d at 92, upheld the bankruptcy court's finding that not to enter an injunction would adversely affect estate property and interfere with reorganization, 837 F.2d at 93, and observed that the "underlying principle of preserving the debtor's estate for the creditors and funnelling claims to one proceeding in the bankruptcy court . . . is a fundamental part of bankruptcy law . . . " 837 F.2d at 94.

Here, PSS's right to take a worthless stock deduction is completely derivative of the losses incurred by PLI. Without those losses PLI would not be insolvent and its stock would not be worthless. The claiming of a worthless stock deduction would affect estate property by terminating PLI's NOL carryovers based on those losses. While plaintiffs have proceeded to confirmation without resolution of the instant issue and it cannot be said that reorganization will totally fail absent preservation of PLI's NOL carryovers, it remains undisputed that the plan proponents expect to utilize NOL carryovers to increase returns to creditors. Here, as in *MacArthur*, entry of a permanent injunction structured to avoid retroactive violation of the automatic stay falls "well within the bankruptcy court's equitable powers which traditionally have been invoked to the end that . . . substance will not give way to form . . . ." 837 F.2d at 94, quoting from *In re UNR Industries, Inc.*, 725 F.2d 1111, 1119 (7th Cir. 1984).[3]

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[3] Disputing that the requisites for a permanent injunction have been established, PSS argues only that plaintiffs have consistently urged that they know exactly how much the NOL is worth and that plaintiffs would proceed with the Joint Plan irrespective of the status of the NOL. In determining whether to grant a permanent injunction, the court will consider preliminarily whether (1) there is real danger that the act complained of will occur; (2) there is more than a mere possibility or

(continued...)

To this, PSS responds that permanently enjoining it from taking a worthless stock deduction post-confirmation impermissively employs §105(a) of the Bankruptcy Code. That

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[3](...continued)

fear that the injury alleged will occur; and (3) there is no adequate legal remedy, *i.e.*, one that is as plain, complete, practical and efficient as the injunction. *State of Connecticut v. Commonwealth of Massachusetts*, 51 S.Ct. 286, 291, 282 U.S. 660, 674, 75 L.Ed. 602 (1931); *General Fireproofing Co. v. Wyman*, 444 F.2d 399 (2d Cir. 1971); Wright and Miller, 11 *Federal Practice and Procedure*, §§2942 and 2944 (Supp. 1983). The third prong is satisfied by, *inter alia*, a showing the plaintiff would suffer irreparable damages in the absence of injunctive relief or that an award of damages would be speculative, *i.e.*, difficult, if not impossible, to measure. *Id.* at §2944. Those elements being established, the court will grant injunctive relief if, in balancing the interests of the parties, the hardship to plaintiff if no injunction is issued outweighs any hardship to defendant if the injunction is granted, as may be mitigated by requiring the plaintiff to post a security bond. *Id.* at §2942.

PSS has indicted that its return for the 1988 tax year in which it claims the deduction will be filed immediately upon the lifting of any legal bar. Decision at 7, note 5. PLI has shown and PSS has not rebutted that PLI's ability to carry forward its NOL would be destroyed by claiming the deduction in a tax year prior to the effective date of the plan. Decision at 22-3, note 18. Lack of an adequate legal remedy is found in that this deprivation is not compensable in damages, since its use is dependent on future income and income from possible acquisitions, Decision at 8, note 6, as well as in that irreparable harm would result from a post-confirmation act retroactively violating the automatic stay.

The balance of hardships tips clearly in favor of the estate and reorganized PLI. In the face of the complete destruction of PLI's NOL carryovers, PSS has advanced no cognizable reason why it may not claim the deduction in a tax year after 1988 in accordance with the tax laws and thereby take advantage of any carrybacks or carryovers it may have, without threatening PLI's NOL carryovers.

section empowers the bankruptcy courts to enter orders "necessary or appropriate to carry out the provisions" of Title 11. 11 U.S.C. §105(a). We agree that this section does not grant a blank cheque and that it is not to be employed "in derogation of specific rules." *In re Pan American School of Travel*, 47 B.R. 242, 244 (Bankr. S.D.N.Y. 1985). But the injunction sought here is carefully tailored to the automatic stay because the worthless stock deduction that PSS seeks to take is for its 1988 tax year, a year ending prior to the effective date of the plan, and will have the effect of terminating PLI's NOL carryovers as of a time when the automatic stay was in place. Plaintiffs do not seek to bar PSS from claiming a worthless stock deduction for any tax year ending after the effective date of the plan. Since the plan provides for cancellation of PSS's stock in PLI, PSS will not hold that stock at the end of any such tax year and PLI's NOL carryovers will not be terminated under §382 of the Internal Revenue Code. Decision at 22-23, note 18. It is because PSS seeks to claim a worthless stock deduction for a tax year ending prior to the effective date of the plan that the claiming of the deduction for such years must be permanently enjoined.

The foregoing constitute this Court's additional findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.

Judgment consistent with this decision is to be entered.

Dated: New York, New York
December 19, 1989

/s/Howard C. Buschman III
United States Bankruptcy Judge

APPENDIX D

Opinion and Decision of the United States Bankruptcy Court for the Southern District of New York, Dated December 4, 1989

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Case No. 86-B-11773

In Re:

PRUDENTIAL LINES, INC.,

Debtor.

Adv. Pro. No. 89-6430A

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS

and

COLD SPRING SHIPPING, L.P.,

Plaintiffs,

-against-

PSS STEAMSHIP COMPANY, INC.,

Defendant.

DECISION

BEFORE: Honorable Howard C. Buschman III
United States Bankruptcy Judge

Appendix D

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The instant motion for a preliminary injunction presents the legal issue of whether a debtor's potential ability to carry over pre-bankruptcy net operating losses is protected by the automatic stay from the claiming of a worthless stock deduction by its parent.

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Plaintiffs, the Official Committee of Unsecured Creditors (the "Creditors' Conmittee") and Cold Spring Shipping, L.P. ("Cold Spring"), seek a preliminary injunction barring defendant PSS Steamship Company, Inc. ("PSS") from claiming a worthless stock deduction for its stock in Prudential Lines, Inc. ("Debtor" or "PLI") in an original or amended federal income tax return for the tax year 1988 or any tax year prior to that in which the confirmation of a plan of reorganization of the Debtor occurs. They assert that the claiming of such a deduction for pre-confirmation tax years would, under the tax laws, destroy the Debtor's $74 million net operating loss ("NOL") carryovers.

I

An involuntary bankruptcy petition was filed on September 12, 1986 against PLI, a corporation organized under the laws of the State of Delaware, pursuant to § 303 of Title 11 of the United States Code (the "Code"). PLI subsequently consented to the entry of an order for relief and has since been operating its business as debtor-in-possession under §§ 1107 and 1108 of the Code.

Defendant PSS, a corporation organized under the laws of the State of Delaware, is a holding company owning all of the outstanding stock of PLI. Its tax basis in that stock is approximately $38,900,000. Tr. at 48; Pls' Exh. 4.[1]

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[1] References to "Tr." and "Exh." are to the transcript of the hearing held on November 21, 1989 and exhibits admitted at that hearing. "Stip." refers to the facts contained in Defendant's Memorandum of Law ("Def's Mem.") at 7-13 to which the parties stipulated at the hearing. Tr. at 13-14.

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The extended Skouras family controls PSS through a series of holding companies and trusts. Stip. at 7-8. Spyros S. Skouras, Sr. was chief executive officer and a director of both PLI and PSS until he resigned in early November 1989 from his positions at PLI. Stip. at 12-13. His son, Spyros S. Skouras, Jr., remains an officer and a director of the Debtor. Tr. at 58.

PLI and PSS are two of four affiliated entities that have filed consolidated federal income tax returns since 1976. Stip. at 9. Of the total $75 million NOL presently available to the four entities, $74 million is attributable to PLI. Tr. at 139; Pls' Exh. 4.

During the course of this case, Plaintiff Cold Spring acquired a participation interest in the deficiency claim of the United States Maritime Administration, likely the Debtor's largest unsecured creditor. Together with the Creditors' Committee, appointed in January 1987 pursuant to § 1102 of the Code, Cold Spring filed a Second Amended Joint Plan of Reorganization dated October 2, 1989 (the "Joint Plan") with the court. A disclosure statement describing the Joint Plan (the "Disclosure Statement") was approved by this Court on October 3, 1989 as containing adequate information in accordance with § 1125 of the Code. Copies of the Joint Plan and accompanying Disclosure Statement were subsequently disseminated to PLI's creditors. A confirmation hearing with respect to the Joint Plan is currently scheduled for December 7, 1989.

Although Cold Spring and the Creditors' Committee will seek to confirm the Joint Plan even were PLI's NOL carryovers to be destroyed, Tr. at 177-8, the Joint Plan contemplates the carryover of PLI's $74 million NOL. It provides, in salient

part, that unsecured creditors are to receive $10 million in notes due five years after issuance and bearing 12.5% interest. Payment of these notes is to be funded by cash contributions of Cold Spring, income from Vessel Charters Inc. a wholly owned operating subsidiary of PLI, and utilization of an Operating Differential Subsidy Contract. It is envisioned by the plan proponents that PL's $74 million NOL will be available to enhance recovery to creditors by reducing tax liabilities on the cash flow of businesses to be acquired, enabling payment ahead of schedule of the notes with the excess cash flow. Tr. at 177-8. The Joint Plan also proposes cancellation of the stock held by PSS and ouster of Spyros S. Skouras, Jr. from management of PLI.

In an objection dated September 19, 1989 to approval of an earlier version of the Disclosure Statement, PLI asserted that the Debtor's NOL would be "effectively eliminated if PSS exercises its right to claim a worthless stock deduction with respect to its stock in the Debtor for 1988." Stip. at 11.[2] Shortly after approval of the Disclosure Statement, Cold Spring focused on that assertion. By letter to PSS, dated October 6, 1989, Cold Spring demanded that PSS disavow the right to take the deduction as represented by PLI. Stip. at 12. Numerous

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[2] Under § 382(a) of the Internal Revenue Code, 26 U.S.C. § 382 (1988), if there is a change in ownership of a loss corporation, the availability of that entity's NOL is limited to the value of the corporation times a prescribed rate of return. A deemed ownership change occurs pursuant to § 382 (g)(4)(D) of the Internal Revenue Code on the last day of the tax year in which a majority shareholder declares its stock to be worthless by taking a loss deduction. PSS reports income on a calendar year basis. Thus, if PSS were to claim a worthless stock deduction for the 1988 tax year, a deemed ownership change would take place on December 31, 1988.

letters between PLI, PSS and Cold Spring[3] culminated in PSS' advising Cold Spring, by letter dated November 6, 1989, that it reserved the right to take the deduction within ten days unless enjoined by a court of competent Jurisdiction. *Id.*

II

Consequently, on November 13, 1989, plaintiffs filed a complaint with this Court seeking a temporary restraining order and preliminary and permanent injunctions against PSS from claiming a worthless stock deduction with respect to its stock in PLI in any tax year prior to the year in which confirmation of a plan of reorganization occurs.

Count one of the complaint asserts that PSS' claiming a deduction in any tax year other than in the year in which Confirmation occurs would breach its fiduciary duty to the Debtor and its creditors. Count two asserts that threats by PSS to take the deduction for the 1988 tax year are an attempt made in bad faith by the Skouras family to defeat the Joint Plan and retain control of PLI in breach of its fiduciary duties to the Debtor and its creditors. In both counts, it is alleged that there is no legitimate tax benefit to be gained by PSS in taking the deduction in 1988 since PSS had no income in that year or in any year to which a loss could be carried back. Count three asserts that PLI's NOL carryovers are property of the estate under the Code and that any act by PSS that would extinguish them or secure their benefit to PSS rather than PLI constitutes a violation of the automatic stay pursuant to § 362(a)(3). Plaintiffs sought preliminary injunctive relief on all counts.

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[3] Requested by plaintiff Cold Spring to demand of PSS that it not claim the deduction for the 1988 tax year, the Debtor declined, claiming it owed fiduciary duties to all parties in interest. Stip. at 12.

Appendix D

Upon the parties' summary showings regarding the need for immediate relief, this Court, on November 13, 1989, issued the temporary restraining order sought against PSS, pursuant to Bankruptcy Rule 7065, pending hearing on the motion for a preliminary injunction.[4]

At the evidentiary hearing held on November 21, 1989 on the motion for a preliminary injunction, however, this Court denied relief under the first count of the complaint, concluding that under applicable law, plaintiffs did not show a probability of success on the merits or serious questions going to the merits.[5] We similarly concluded that the Plaintiffs failed to

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[4] Bankruptcy Rule 7065 makes Rule 65 of the Federal Rules of Civil Procedure applicable to adversary proceedings. Under Rule 65(b), a temporary restraining order may be granted "upon a summary showing of its necessity in order to prevent immediate and irreparable injury." Fed. R. Civ. P. 65(b). On a motion for preliminary injunction, the movant must establish "irreparable harm and either (1) probable success on the merits or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation plus a balance of hardships tipping decidedly in plaintiff's favor." *Jackson Dairy, Inc. v. H.P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979). Where an act would violate the automatic stay, irreparable harm is established by the violation since Congress, by legislatively staying such acts, has determined that they cause irreparable injury to the estate. *Beker Ind. Corp. v. Florida Land and Water Adjudicatory Commission (In re Beker Inc. Corp.)*, 57 B.R. 611, 621 (Bankr. S.D.N.Y. 1986).

[5] Skouras, Sr. credibly testified that PSS sought to take the deduction for the 1988 tax year on advice of Battle Fowler and BDQ Seidman, its attorneys and its accountants, respectively, Tr. at 30-6, 44; that PSS was being pressured by and was obligated to its minority shareholders, dissident members of the Skouras family, to take the deduction in that year, Tr. at 53-4; that PSS' federal income tax return for 1988 was prepared and would be filed immediately upon the lifting of any legal

(continued...)

demonstrate a probability of success of the second count, the gravamen of which is that Skouras Jr. threatened that PSS would take the deduction in order to distort the creditor process. No evidence supporting that claim was adduced.

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[5](...continued)

bar, Tr. at 44; that PSS sought the deduction to build its own NOL by which it could offset any deemed income expected as a result of cancellation of indebtedness by Chase Manhattan Bank, N.A., Tr. at 47-8, 54-6. It thus became apparent during the hearing that PSS planned to take the deduction for its own purposes and not merely to advance the efforts of Spyros S. Skouras, Jr. to defeat the Joint Plan. If PSS' taking the deduction would eliminate the Debtor's ability to carry forward its $74 million NOL, such act would preclude enhancement of any plan of reorganization, not only that of the plaintiffs, but also that which Skouras Jr. hopes to advance if the Joint Plan is defeated. Tr. at 162-4. Applying Delaware corporate law, this Court held that the state law issue is to be judged by fairness and the business judgment rule. *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967); *see also, Western Pacific R.R. Corp. v. Western Pacific R.R. Co.* 197 F.2d 994, *reh'g denied*, 197 F.2d 1012 (9th Cir. 1951), *vacated and remanded on other grounds*, 345 U.S.247, 73 S.Ct. 646, 97 L.Ed. 986 (1953), *prior opinion aff'd*, 206 F.2d 495 (9th Cir. 1953), *cert. denied*, 346 U.S. 910, 74 S.Ct. 242, 98 L.Ed. 407, *reh'g denied*, 346 U.S. 940, 74 S.Ct. 376, 98 L.Ed. 428 (1954); *Case v. New York Central R.R. Co.*, 232 N.Y.S.2d 702 (1962), *rev'd*, 19 A.D.2d 383, 243 N.Y.S.2d 620 (1963), *rev'd*, 15 N.Y. 2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643 (1965). Here PSS had a valid business reason for taking eh deduction and there was no gross overreaching by PSS. Thus the court did not pass upon the business judgment of PSS' management. *See, Meyerson*, 246 A.2d at 794; *see also, Western Pacific*, 197 F.2d 994; *Case*, 15 N.Y.2d 150. This court also held that while Delaware law prohibits a director from using the subject corporation to further its own interests and requires it to protect the interests of the corporation, it does not require a shareholder to forego tax benefits to which it is entitled under the Internal Revenue Code merely because it is the sole shareholder of the corporation. *Meyerson*, 246 A.2d at 791-2; *see also, Western Pacific*, 197 F.2d at 1004.

Moreover, since it was shown that PSS' return claiming the declaration was to be filed immediately upon the lifting of any legal restraints and the claiming of the deduction would adversely impact Skouras Jr.'s hopes to reorganize PLI, the evidence rebuffed the theory alleged.[6]

The court reserved decision on whether termination of a debtor's NOL is barred by § 362(a)(3) of the Code.[7] That question presents two issues: (i) is the right to carry forward an NOL "property" of an estate as envisioned by that section and (ii) if so, is the taking of a worthless stock deduction by a sole shareholder an exercise of control as also envisioned. These are issues of first impression. Although we initially treated with considerable skepticism plaintiffs' claim that the automatic stay bars taking a worthless stock deduction by a parent of a debtor-in-possession, analysis of the statute, legislative history and policy considerations require that result.

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[6] Although PSS in its brief argued that it was far from clear whether the Debtor's ability to carry over its NOLs would be eliminated as a result of the deduction in 1988, the hearing proceeded on the basis that PLI's NOL carryovers would be terminated. Tr. at 96, 210. Accordingly, irreparable harm was found in that termination of the NOLS would constitute a deprivation of a tax attribute or property not be compensable in damages. Tr. at 210-11.

[7] Section 362(a)(3) provides that the filing of a bankruptcy petition automatically stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

Appendix D

III

A.

Because the terms of art of an integrated statute are generally to be interpreted consistantly,[8] the definition of property under § 362(a)(3) is governed by § 541 where Congress sought to define the scope of a bankruptcy estate's property. In § 541(a)(1) it is provided that "such estate is comprised of all of the following property wherever located and by whomever held:

> (1) . . . all legal or equitable interests in property as of the commencement of the case." § 541(a)(1).

That the term "property" is broader than tangible physical property, claims to property, and causes of action is made clear by § 541(b)(1). In that section, Congress excluded from the term "property" "any power that the debtor may only exercise solely for the benefit of an entity other than the debtor . . . ." § 541(b)(1). Powers that a debtor may exercise for its own benefit are, therefore, included or there would be no need for the exemption. Since the provisions of § 541 in their entirety are to be viewed "as definition of what is included in an estate rather than a limitation," *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 103 S.Ct. 2309, 2312, 76 L.Ed.2d 515 (1983), it follows from the language of the statute that other non-leviable or even non-transferable rights of a debtor come within the broad embrace of § 541(a)(1) and its definition of the composition of a bankruptcy estate, notwithstanding that the right may not fall within more traditional or common law

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[8] *See*, F. Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 528, 537-8 (1947).

concepts of property.[9] The statutory language thus implies that a tax attribute, such as the potential ability of a debtor-in-possession and reorganized debtor to use loss carryovers to offset future taxable income, falls within the ken of property under § 541(a)(1).

Such a result, moreover, flows from § 346(h). That section expressly contemplates that NOLs belong to the bankruptcy estate. It provides:

> Notwithstanding sections 728(a) and 1146(a) of this title, for the purpose of determining the number of taxable periods during which the debtor or the *estate may use a loss carryover or a loss carryback*, the taxable period of the debtor during which the case is commenced is deemed not to have been terminated by such commencement.

§ 346(h) (emphasis added). Since there is no provision that expressly provides for the inclusion of NOLS in an estate of corporate debtor,[10] it appears that Congress must have

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[9] The limitations of former § 70a(5)'s definition of property to alienable or leviable property in the debtor's possession was discarded by Congress in enacting § 541 of the Bankruptcy Code. Compress intended to include within the § 541(a) definition of property "all interests, . . . contingent interests and future interests, whether or not transferable by the debtor." H.R. Rep. No. 595, 95th Cong. 1st Sess. 175 (1977).

[10] Section 346(i) provides that loss carry forwards belong to the bankruptcy estates of individuals to the extent utilized by the trustee and revert to the debtor on closing of the case. *See also*, § 1398(g) of the Internal Revenue Code. It was apparently enacted to address the Supreme Court's concern, expressed in *Segal v. Rochelle*. 382 U.S. 175, 86 S.Ct.

(continued...)

contemplated that NOLS came into a bankruptcy estate through the provisions of § 541(a)(1).

B.

While it might be argued that § 346(h) applies for tax purposes only,[11] careful examination of the legislative history confirms that estate property includes a debtor-in-possession's right to carry forward an NOL.

The identical reports of both houses of Congress observed with respect to § 541(a)(1):

> the estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, cause of action (see Bankruptcy Act § 70a(6)), and all other forms of property currently specified in section 70a of the Bankruptcy Act § 70a. *The result of Segal v.*

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[10](...continued)
511, 15 L. Ed. 2d 428 (1966), for the fresh start individuals obtain upon discharge. See discussion *infra*. That the failure to expressly provide that estate property includes the right of corporate debtors to use NOLs is of no significant consequence since Congress made reference to individuals in the context of addressing that concern.

[11] *But see, Holder v. Wilson (In re Wilson)*, 49 B.R. 19, 20-21 (Bankr. N.D. Tex 1985), wherein the Court held that § 346(i) codified the holding in *Segal* and required that NOL carrybacks attributable to an individual debtor and giving rise to a tax refund be included within the definition of estate property.

Appendix D

Rochelle, 382 U.S. 375 (1966), *is followed, and the right to a refund is property of the estate.*

H.R. Rep. No. 95-595, 95th Cong. 1st Sess. 367 (1977); S. Rep. No. 95-989, 95th Cong. 2d Sess. 82 (1978) (emphasis added).

Segal v. Rochelle, 382 U.S. 375, 86 S.Ct. 511, 15 L. Ed. 2d 428 (1966), involved the closely analogous issue of whether a NOL carryback is property of a bankruptcy estate. The debtors, two partners and their partnership, commenced their bankruptcy cases by filing bankruptcy petitions at the end of the third quarter of 1961. After the close of that calendar year, the partners filed for tax refunds for the two years prior to the year of the bankruptcy by applying and carrying back losses incurred by the partnership in 1961 prior to the filing of the bankruptcy petitions. The Court held that the potential claims for loss carryback refunds due to pre-bankruptcy losses are property of the estate.

In so holding, the Court ruled that bankruptcy purposes controlled the definition of property under § 70a(5) of the Bankruptcy Act, 11 U.S.C. § 110a(5) (1970) (repealed), the predecessor to § 541(a)(1), rather the meanings attributed to "property" in other contexts. It added:

> The main thrust of § 70a(5) is to secure for creditors everything of value the bankrupt may possess in alienable or leviable form[12] when he files his petition. To this end the term "property" has been construed most generously and an interest is not outside its reach because it is novel or contingent or

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[12] *See*, n. 9, *supra*.

> because enjoyment must be postponed . . . Turning to the loss-carryback refund claim in this case, we believe it is sufficiently rooted in the pre-bankruptcy past and so little entangled with the bankrupts' ability to make an unencumbered fresh start that it should be regarded as "property" under § 70a(5).

382 U.S. at 379-80.

Thus, at commencement of the bankruptcy case, the debtors in *Segal* had, like the debtor here, pre-bankruptcy net operating losses that might, depending on compliance with the Internal Revenue Code, be applied advantageously. By expressly referring to *Segal*, the legislative history consequently demonstrates a congressional intent that NOLs be included in estate property under the Code.

C.

The *Segal* Court characterized NOLs as a potential claim for refunds due to the carryback provisions of the Internal Revenue Code. Here, the movants desire to preserve those losses to apply in the future if a plan reorganizing the debtor is confirmed and if the reorganized debtor has income. Does the difference lead to a differentiation in result?

In *Segal*, the debtors argued that, since the trustee's claim to the refunds depended on the notion that an NOL is estate property, to hold that the refunds belonged to the estate was also to hold that loss carryovers likewise belonged to the estate. *Segal*, 382 U.S. at 381. They argued that to so hold would force bankrupt estates to be kept open for long periods. In cases involving individuals, this assertion appeared to disturb the Court, seemingly because an individual's fresh start might

be unduly penalized due to the inability to use NOL carryovers not likely to be utilized by a trustee in liquidating an estate:

> While in fact the trustee can obviate this detriment to the estate - by selling a contingent claim in some instances or simply foregoing it - inconvenience and hindrance might be caused for the bankruptcy individual. Without ruling in any way on a question not before us, it is enough to say that a carryover into post-bankruptcy years can be distinguished conceptually as well as practically. The bankrupts in this case had both prior not income and a net loss when their petitions were filed and apparently would have deserved an immediate refund had their tax year terminated on that date; by contrast, the supposed loss carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all.

Id.

Section 346(i) of the Bankruptcy Code addresses this concern. It provides that an individual's bankruptcy estate succeeds to loss carryovers; that they are returned to the debtor when the case is closed or dismissed to the extent not utilized; and that the debtor may utilize any NOLs as though the applicable periods for the use of loss carryovers were suspended in the interim.

The conceptual and the practical distinctions noted by the Court simply disappear in the case of a reorganized company. Plans involving companies such as White Motor Corp., Allis-Chalmers Corp. and McLean Industries, Inc., all having significant NOLS, have been confirmed long before the

expiration of loss carryover periods. Final decrees are issued in Chapter 11 cases when a plan of reorganization is substantially consummated. *See* § 1101; Bankruptcy Rules 2015(a)(6), (7), 3022. If a debtor corporation is liquidated either under Chapter 7 or pursuant to a Chapter 11 plan, no discharge is granted, §§ 727(a)(1), 1141(d)(3), and there is no concern for a fresh start. Unless the corporation is reorganized, NOL carryovers will apparently be lost. Nor does the indefiniteness or the contingency of a loss carryover make a loss carryover any less estate property. Contingent and future interests of a debtor are estate property. *See* n. 9 *supra*.[13] Thus, in the case of a corporate debtor, there appears no cognizable reason to differentiate loss carryovers from carrybacks.

D.

Strong policy reasons, moreover, support the conclusion that debtor's potential ability to utilize NOLs is property of an estate. While the definition of property of an estate does not depend on the property having any value, it cannot be gainsaid that "the right to use the loss as an offset . . . is valuable . . . The market for it is restricted, of course, but this detracts nothing from its value to one in a position to utilize it." *Western Pacific R.R. Corp. v. Western Pacific R.R. Co.*, 345 U.S. 247, 276, 73 S.Ct. 656, 97 L.Ed. 986 (1953) (Jackson, J. dissenting). It is only just and appropriate that creditors be given the opportunity

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[13] The language of §541, moreover, so confirms. Section 541(a)(5) limits contingent future interests only in instances involving bequests, inheritance, matrimonial settlements and life insurance policies to the actual property so received by a debtor within 180 days of the filing of the bankruptcy petition. Other contingent future interests in property are not so limited.

to attempt to realize on that value. They have not been paid because of the very losses giving rise to the NOLs. Their shortfall should not be increased further through failure to recognize loss carryforward rights as part of a bankruptcy estate.[14]

To this defendant responds that the Internal Revenue Code does not treat NOLs as property in, for example, allocation of purchase price among assets acquired in the acquisition of a trade or business, *see*, I.R.C. § 1060; Temp. Treas. Reg. 1.338(b)-2T; that NOLs are more like a tax exemption held not to be property in *In re Heritage Village Church-Missionary Fellowship*, 87 B.R. 401, 405 (D. S.C. 1988); that they are created by statute and taken away by statute; and that recognizing NOLs as property could yield "untoward results;" consisting principally of the threat of applicability of fraudulent transfer law and alleged difficulty in allocation of NOLs anong affiliates in bankruptcy. Def's Mem. at 14-20.

In *Segal*, however, the Court held that property of an estate is to be defined by bankruptcy purposes, not by the Fifth Amendment's Just-Compensation clause or a state taxing statute. *Segal*, 382 U.S. at 379. The same reasoning applies to attempts to define estate property by the Internal Revenue Code: the purposes differ. To be sure, ability to use an NOL depends on compliance with the tax laws, just as a debtor's ability to utilize a mine depends on compliance with applicable state and local regulation. *See*, *Beker Ind. Corp. v. Florida Land and Water Adjudicatory Commission (In re Baker Ind. Corp.)*, 57

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[14] Indeed, Skouras Jr. testified at the hearing that he believed that PLI's $74 million NOL was "an important potential asset of the estate," Tr. at 62; that he "hoped" it would be a "valuable asset of the estate," *id.*; and that "among the assets the Debtor possessed was a net operating loss," Tr. at 88.

B.R. 611, 622-4 (Bankr. S.D.N.Y. 1986). But that dependence does not mean the absence of a property right. *Id.* To the extent that *Heritage Village*, a case where the IRS sought to revoke a debtor's tax exempt status implies anything more than that such a revocation is exempt from the automatic stay by virtue of § 362(b)(4), *see*, 87 B.R. at 404, it is not followed here.[15] In *Beker* it was held that similar good faith governmental revocation of a permit is not within the bar of 362(a)(3).[16]

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[15] Moreover, the *Heritage Village* Court stated that § 362(a)(3) bars assessment of taxes by the Internal Revenue Service, 87 B.R. at 405, thereby failing to recognize that § 362(b)(9), added in 1986, exempts the issuance of a notice of tax deficiency by a governmental unit from the automatic stay. In *Bob Jones University v. Simon*, 416 U.S. 725, 94 S.Ct. 2038, 40 L. Ed. 2d 496 (1974), the Supreme Court held that the Anti Injunction Act, 26 U.S.C. § 7421, prohibits enjoining the revocation of tax exempt status on the ground that, although the Anti Injunction Act barred only law suits brought for the purpose of restraining assessment and collection of taxes, revocation of the exemption was a prelude to assessment. Since revocation is a prelude to a notice of deficiency, it would fall within the exemption provided by § 362(b)(9). 416 U.S. at 731-33. Thus, the *Heritage Village* court's ruling that a tax exemption is not property within § 362(a)(3) was unnecessary to its holding that revocation is not barred by the automatic stay.

[16] In asserting that NOLs are not property of the estate, defendant relies on *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983) and *D.H. Overmeyer Telecasting Co. v. Lake Erie Communications, Inc. (In re D.H. Overmeyer Telecasting Co.)*, 35 B.R. 400 (Bankr. v. N.D. Ohio 1983). *Braniff* held that Federal Aviation Administration rules limiting air carrier operation to landing slots do not create property rights. 700 F.2d at 942. The *Overmeyer* Court held that a license issued by the Federal Communications Commission is not property. 35 B.R. at 401-03. Both

(continued...)

Of more significance is the assertion that recognition of NOLs as estate property will induce instability in pre-bankruptcy tax returns of affiliated companies through the application of fraudulent transfer statutes such as § 548 of the Bankruptcy Code where tax savings have been achieved through the filing of a consolidated return or where a worthless stock deduction has been taken by a parent. To this is added the notion that a corporation generally has no interest in transactions in its stock.

Like the *Segal* Court, we do not decide these issues and we note that the consequences alleged are largely hypothetical and not necessarily unjust. If the fraudulent transfer section of the Code, § 548, were to apply, it would be through an intended detriment to creditors or the failure of a debtor to receive

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[16](...continued)

cases failed to recognize that, in enacting §541, Congress intended inclusion of interests, whether or not transferable, in its expansion of property of the estate. *Overmeyer*, moreover, was decided prior to the Supreme Court's ruling in *Whiting Pools* that estate property is to be broadly defined and *Braniff*, although decided after the Supreme Court's decision, failed to cite it. Accordingly, this Court, following *Bernstein v. B.C. Williams, Inc. (In re Rocky Mtn. Trucking Co.)* 47 B.R. 1020 (D. Colo. 1985) (holding that a license is estate property) and applying *Whiting Pools*, so distinguished those cases and held in *Baker Ind. v. Florida Land and Water Adjudicatory Commission (In re Beker Ind. Corp.)*, 57 B.R. 611 (Bankr. S.D.N.Y. 1986), that a debtor-in-possession's right to truck its products from its mine, although subject to state and local regulation, lies within the purview of property of the state. 57 B.R. at 622. The *Heritage Village* Court also failed to consider *Whiting Pools*.

reasonably equivalent consideration while insolvent.[17] It is hardly contrary to bankruptcy purposes to avoid transactions so motivated or to require a solvent affiliate having positive income to return to an insolvent debtor its share of tax savings achieved through the filing of a consolidated return utilizing losses generated by the debtor during the one year pre-bankruptcy period permitted by § 548 Of the Code if the debtor failed to receive reasonably equivalent value. In *Western Dealer Mgmt., Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp.)*, 473 F.2d 262 (9th Cir. 1973), *cert. denied*, 412 U.S. 919, 93 S. Ct. 2734, 37 L. Ed. 2d 145 (1973), the court held that a parent of a debtor who received a tax refund through filing a post-bankruptcy consolidated tax return including the debtor held the entire refund in trust for the bankruptcy estate since it was due to the carryback of pre-bankruptcy NOLs of the debtor. No cognizable reason appears why the result should be any different if a consolidated return were filed pre-bankruptcy and an insolvent debtor failed to receive reasonably equivalent

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[17] Section 548(a)(1) of the Code, § 7 of the Uniform Fraudulent Conveyance Act ("UFCA"), and § 4(a)(1) of the Uniform Fraudulent Transfer Act ("UFTA") invalidate transfers made with actual intent to hinder, delay or defraud present or future creditors of the transferor. Those statutes also void transfers amounting to constructive fraud, *i.e.*, made by a transferor who is or is thereby rendered insolvent if it failed to receive "reasonably equivalent value" under § 548(a)(2) of the Code and UFTA § 5(a) on "fair consideration" under UFCA § 4. *See*, Murdoch, Sartin and Zadek, Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles, 43 The Business Lawyer 1, 9-11 13 (1987). Since our task is to define property of a bankruptcy estate in light of bankruptcy purposes as *Segal* commands, we consider only transfers that are fraudulent under § 548 of the Bankruptcy Code. While a trustee may bring a fraudulent transfer suit under state law, that cause of action is measured by state law. The definition of property under those statutes may be governed by purposes other than federal bankruptcy purposes.

consideration from the affiliate. Although the allocation of such savings is normally governed by the business judgment rule, *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967); *see also*, *Western Pacific R. R. Corp v. Western Pacific R.R. Co.*, 197 F.2d 994, *reh'g denied*, 197 F.2d 1012 (9th Cir. 1951), *vacated and remanded on other grounds*, 345 U.S. 247, 73 S.Ct. 656, 97 L.Ed 986 (1953), *prior opinion aff'd*, 206 F.2d 495 (9th Cir. 1953), *cert. denied*, 346 U.S. 910,, 74 S.Ct. 242, 98 L.Ed. 407 (1953), *reh'g denied*, 346 U.S. 940, 74 S.Ct. 376, 98 L.Ed. 428 (1954); *Case v. New York Central R.R. Co.*, 232 N.Y.S.2d 702 (1962), *rev'd*, 19 A.D.2d 383, 243 N.Y.S.2d 620 (1963), *rev'd*, 15 N.Y.2d 150, 256 N.Y.S.2d 607, 264 N.E.2d 643 (1965), the business judgment rule does not apply in fraud cases. *Meyerson*, 246 A.2d at 794; *see also*, *Western Pacific*, 197 F.2d at 994; *Case*, 15 N.Y.2d 150. Indeed, one would think that in most cases the concern will not arise in view of the support that most parents afford subsidiaries and thus the presence of reasonably equivalent consideration.

Similar considerations would seem to apply to cases where a parent takes a worthless stock deduction pre-petition thereby limiting or eliminating prior NOL carryforwards of its prospectively bankrupt subsidiary. Reasonably equivalent consideration might be found. In any event, one would think the carryover consequences of terminating or limiting a prospective bankrupt's NOLs pre-bankruptcy are largely hypothetical. A worthless stock deduction can be taken only if the stock is truly worthless, including consideration of the possibility of reorganization in bankruptcy. Rev. Ruling 77-17, 1977-1 C.B. 44. If the situation is so bleak that only liquidation is in the offing, then NOL carryovers would generally be worthless to a corporate debtor since there will be no future income to offset. Thus, nothing of value would have been

appropriated by the claiming of the deduction. If there is a prospect of reorganization, either as a going concern or through creation of an investment vehicle, the deduction will likely be unavailable pre-bankruptcy given that few, if any, Chapter 11 debtors seeking to reorganize as a going concern will concede initially that shareholders are not likely to be participants in the reorganized company, as is required to sustain the deduction. *See, Id.*

Nor does the task of separating NOLs among bankrupt affiliates raise the daunting spectre forecast by defendant. There appears no reason why skilled accountants cannot perform these tasks, regardless of whether the companies are in bankruptcy. *See*, R.A. Jacobs, Post-TAMRA Chapter 11 Corporate Tax Survival Kit, U.S.C. L. Center Forty-First Tax Inst. ¶705 (Matthew Bender 1989) for a discussion of such an allocation. Indeed, in this very case, the parties have been able to determine that $74 million of the $75 million NOLs reflected on the consolidated tax return of four affiliated companies belong to PLI.

It thus remains that there are compelling bankruptcy purposes for including NOL carryforwards within the ken of estate property. The losses relate to the period when creditors were not paid and any value to be obtained should belong to them. The statutory language, legislative history and better reasoned case law permit no other conclusion. We, therefore, turn to the issue of whether the taking of a worthless stock deduction is an exercise of control over a debtor's NOLs.

IV

Section 362(a)(3) stays "any act to obtain possession of property of the estate or of property from the estate or to

exercise control over property of the estate." This Matter was tried by both sides on the theory that by taking a worthless stock deduction, PSS will eliminate PLI's ability to carry forward its NOLs. *See*, Tr. at 96, 210.[18]

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[18] While PSS, in its brief, argues that that result is not certain, it gives no cogent reason for the alleged lack of certainty.

Under § 382 of the Internal Revenue Code, the utilization of NOL carryovers is limited if there is an ownership change defined by that section. The claiming of worthless stock deduction by a more than 49% shareholder will cause an ownership change if the owner retains its stock at the end of the tax year in which the deduction is claimed. § 382(g)(4)(D); Jacobs, § 702.1. Because the value of the corporation prior to the ownership change is limited generally to the value of its stock immediately prior to an ownership change, § 382(e)(1), and a worthless stock deduction can only be taken if the stock is worthless, the claiming of the deduction by a 100% shareholder such as PSS will apparently render all NOL carryovers of the subject corporation valueless. Section 382(a) imposes the so-called "§ 382 limitation" for carryovers limiting them to the value of the corporation prior to the ownership change multiplied by the long term tax-exempt rate. Thus, it appears that since the value of the stock will be zero if a worthless stock deduction is claimed by a 100% shareholder, the "§ 382 limitation" will be zero.

If the subject corporation is in bankruptcy, § 382(l)(5) states that the "§ 382 limitation" does not apply if the old loss corporation is the subject of a bankruptcy case or similar court proceeding immediately prior to the ownership change and if the shareholders and "old and cold" creditors of the corporation own at least 50% of the stock after the ownership change. Jacobs, § 702.3. This provision would appear to contemplate an ownership change as a result of a plan of reorganization, foreclosure or receivership, not a worthless stock deduction. *C.f.* Jacobs, § 701.2. If so, the "§ 382 limitation" would apparently apply to an ownership change caused by the claiming of a worthless stock deduction by a 100% shareholder before the effective date of a plan of

(continued...)

Appendix D

The contours of the open-ended phrase "exercise control" have been only partially described by case-law. In *Beker* this Court held that it did not apply to good-faith governmental regulation of the use of estate property, ruling that it was highly unlikely that Congress, in adding that phrase in P.L. 98-353 (1984), intended to overrule legislatively the government regulation exemption from the automatic stay sat forth in § 362(b)(4). *Beker*, 57 B.R. at 626. In *Pension Benefit*

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[18](...continued)
reorganization and NOL carryovers would be lost.

If a worthless stock deduction is claimed by a 100% shareholder for a taxable year in which a confirmed plan of reorganization became effective or within a two year period thereafter, there is a possibility that NOL carryforwards will be lost. Section 382(l)(5)(D) reimposes the "§ 382 limitation" if another ownership change occurs within two years after an ownership change pursuant to a bankruptcy plan of reorganization and further provides that the "§ 382 limitation" is deemed to be zero for any taxable year after the second ownership change. Thus, the claiming of a worthless stock deduction by a 100% shareholder within two years after the effective date of a plan could eliminate NOL carryover for subsequent years.

If the reorganization plan, however, provides for cancellation of the stock held by the 100% shareholder, it appears that claiming a worthless stock deduction post-effective date would not affect NOL carryovers. In providing for an ownership change upon the claiming of a worthless stock deduction, § 382(g)(4)(D) conditions the ownership change upon the stock being held at the close of the taxable year in which the deduction was claimed. This provision was added to overrule *Textron v. United States*, 561 F.2d 1023 (1st Cir. 1977) and prevent a double deduction if the parent retains its stock. That condition will not be met if the stock is cancelled and consequently no ownership change should occur by virtue of claiming the deduction after cancellation. Thus, NOL carryforwards should be preserved to the extent permitted by other parts of §382, *see e.g.*, §382(1)(5)(C) and Jacobs, § 702.3 regarding reduction in carryovers on exchange of debt for stock.

Appendix D

Guaranty Corp. v. the LTV Corporation (In re Chateaugay Corp.), 87 B.R. 779 (S.D.N.Y. 1988), *aff'd* 875 F.2d 1008 (2d Cir.), *cert. granted on another issue*, ____ U.S. ____, 110 S.Ct. 321, ____ L.Ed.2d ___, 58 U.S.L.W. 3288 (Oct. 30, 1989) (No. 89-390), the court ruled that the P.B.G.C.'s restoration of a debtor's terminated pension plans did not violate § 362(a)(3): the restoration was not an exercise of control over estate property although it reinstated obligations of the debtor to provide pension benefits to employees. 87 B.R. 805-06. In *Continental Air Lines, Inc. v. Hillblom*, 61 B.R. 758 (S.D. Tex. 1986), the court held that § 362(a)(3) did not bar litigation against debtor arising from debtor's post-petition attempt to take over another corporation because the litigation sought to vindicate rights of the target corporation rather than to obtain a favorable position *vis a vis* the debtor's creditors, 61 B.R. at 776-779.

As stated in *Beker*, 57 B.R. at 626 and *Hillblom*, 61 B.R. at 776, 779, the control provision of § 362(a)(3) is to be defined by the underlying congressional purposes of preventing dismemberment of the estate and assuring orderly distribution.

The claiming of a worthless stock deduction having the effect of terminating potential use of loss carryovers violates the first of those purposes. It dismembers the estate by eliminating a potential that may be of benefit to creditors. That the effect is due to the legal consequences of the act is of no importance. *In re 48th Street Steakhouse, Inc.*, 61 B.R. 182 (Bankr. S.D.N.Y. 1986), *aff'd*, 77 B.R. 409 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 427 (2d Cir. 1987), *cert. denied, Rockefeller Group Inc. v. 48th Street Steakhouse, Inc.*, ___U.S.___, 108 S.Ct. 1596, 99 L. Ed. 2d 910 (1988). There the court held that § 362(a)(3) barred a landlord from terminating the lease of its

tenant where the effect under state law would be to terminate a sub-lease hold by the debtor-in-possession.

Nevertheless, PSS, citing to legislative history pertaining to § 362(a)(1), argues that the sole purpose of the automatic stay is to afford a breathing spell and creditor protection by barring creditors from unilateral acts to the detriment of other creditors; that PLI's NOLs are subject to PSS' determination of when to take a worthless stock deduction; and that PLI, pre-petition, had no ability to affect that determination. To PSS, barring it from taking the deduction affords PLI an unintended windfall. These contentions are without merit.

It cannot be gainsaid that § 362(a)(1) in designed to afford a breathing spell and creditor protection by staying proceedings brought on pre-petition claims. Section 362(a)(3), however, is designed to afford additional protection permitting the bankruptcy process to work by a debtor to keep estate property intact during the process at least until it becomes apparent that a feasible reorganization cannot be achieved in a reasonable period of time. *C.f. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Inc.*, 484 U.S. 365, 376, 108 S.Ct. 626, 632, 98 L.Ed 2d 740, 751 (1988).

That PLI's NOL carryovers are subject to PSS' ability to take a worthless stock deduction is irrelevant. It is elementary, for example, that estate property subject to a lien is protected by § 382(a) from foreclosure even though a debtor had no defense to foreclosure prior to bankruptcy. The bar is not a windfall; it preserves estate property.

Accordingly, we hold that to claim the deduction would constitute a violation of the stay contained in § 362(a)(3) and

should be enjoined. The foregoing constitutes this Court's findings of fact and conclusions of law pursuant to Bankruptcy

Rule 7052.

Settle Order.

Dated: New York, New York
December 4, 1989

/s/Howard C. Buschman III
United States Bankruptcy Judge

APPENDIX E

Elliot Pisem and Peter A. Glicklich
"Was the Bankruptcy Court Lost at Sea? Prudential Lines Collides with the Internal Revenue Code"
American Bankruptcy Institute Newsletter
(May/June 1990) Reprinted in *Tax Notes*, Sept. 17, 1990

The Bankruptcy Court for the Southern District of New York took two giant steps over the line that divides bankruptcy lawyers from tax lawyers -- some might even call it poaching -- on December 4 and December 19, 1989, when it issued its opinions in *In re Prudential Lines, Inc. (Official Committee of Unsecured Creditors v. PSS Steamship Co.)*, 107 Bankr. 832, *further proceedings*, 19 Bankr. Ct. Dec. (CRR) 1945. The court's decision turned on the meaning of the term "property of the estate" in the automatic stay of section 362(a)(3) of the Bankruptcy Code (which prohibits any "exercise [of] control" over property of a debtor); in the course of its opinion, however, the court adopted a view of the filing of tax returns and the nature of net operating loss ("NOL") carryovers that would shock most tax lawyers. The court also cited a number of cases that bear on the sharing of tax liabilities and tax refunds among members of the group is under the jurisdiction of a bankruptcy court; that portion of its discussion may also lead to some novel conclusions.

TAX BACKGROUND

In order to appreciate the stakes in *Prudential Lines*, some background regarding the tax treatment of NOL carryovers and the sharing of tax liabilities among affiliates is necessary.

Appendix E

Net Operating Losses

In order to ameliorate the potentially drastic consequences of taxing income strictly on an annual basis and to stimulate investment in new and risky ventures, the Internal Revenue Code ("IRC") permits an NOL for a taxable year to be carried back and forward to other taxable years in order to be claimed as a deduction against the income of those years. In normal circumstances, a corporation may carry an NOL back for three taxable years from the year in which the loss is incurred and then forward for fifteen more years and may obtain a refund of any overpayment of tax caused by an NOL carryback that reduces or eliminates taxable on which tax was previously paid.

Following an "ownership change" of a corporation with an NOL carryover (a "loss corporation"), IRC section 382 limits the loss corporation's ability to use the carryover to offset income arising after the ownership change, in order to prevent "trafficking" in carryovers. The section 382 limitation for each taxable year after the ownership change is generally determined by multiplying the fair market value of the loss corporation's stock on the date of the ownership change by a statutory "long-term tax-exempt [interest] rate." (The long-term tax-exempt rate changes monthly under a formula set out in the IRC and was 7.05% for May 1990, when this article was written.) However, certain provisions may relieve a debtor corporation in bankruptcy proceedings (the value of whose stock and, thus, whose section 382 limitation are likely to be very low) from some of the rigors of section 382 and these might apparently have been available to the debtor in *Prudential Lines*, provided that it did not undergo an ownership change *prior to* completion of its chapter 11 proceeding.

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An ownership change occurs under section 382 when, on any date during a three-year testing period, there has been an aggregate increase in ownership of more than 50 percentage points in the stock of the loss corporation by its 5-percent shareholders. A "5-percent shareholder" includes any person holding 5% or more of the stock of the loss corporation at any time during the testing period.

In one situation, section 382 deems shares to have been acquired even though there may have been no direct or indirect transfers of loss corporation stock. This rule applies if a shareholder "treat[s] ... as becoming worthless" *any* stock of the loss corporation and if that shareholder owned, at any time during the three-year period ending on the last day of the shareholder's taxable year, 50% or more of the stock of the loss corporation. If these conditions are met, the ownership interest represented by those shares of the loss corporation actually owned by the shareholder on the last day of that year (which, because of interim transactions, might then constitute less than 50% of the stock of the loss corporation) is treated as newly acquired on the first day of the next year.

The IRC does not describe what a shareholder must do in order to "treat as worthless" stock in the loss corporation. The legislative history of this provision makes clear, however, that what matters is the shareholder's claiming a "worthless stock" deduction. A worthless stock deduction generally is allowable with respect to any share of stock that becomes wholly worthless during the taxable year, even though the taxpayer has not abandoned or otherwise disposed of it. There is a "use it or lose it" quality to any worthless stock deduction: it is deductible only in the year the stock becomes worthless. Even if the taxpayer later actually disposes of the stock and "realizes" the loss, no deduction is allowable in the year of disposition if the

stock was in fact worthless in a prior year. Thus, if a taxpayer is barred from claiming its loss in the year of worthlessness, it will never be able to take account of the economic loss that it has suffered in computing its taxable income.

Tax returns are signed under penalties of perjury as being true, correct, and complete and it is uncertain whether a taxpayer has the right simply to "waive" a claim for a deduction. There is, therefore, at least a theoretical question whether, if a taxpayer believes it is entitled to a worthless stock loss, but does not take the deduction in order for a loss subsidiary to avoid a section 382 limitation, the taxpayer may be subjected to penalties for filing an incomplete or incorrect return or for aiding the subsidiary in avoiding *its* rightful tax liability.

Consolidated Returns

There is another more common and direct way in which a parent or other affiliate of a loss corporation may affect the amount of another corporation's loss carryovers and that is by utilizing the losses in a consolidated income tax return.

An "affiliated group" of corporations (a common parent corporation and one or more includible subsidiaries, connected through 80% stock ownership) may file consolidated Federal income tax returns. The common parent corporation during a given taxable year is the sole agent for each subsidiary in the group in dealing with the IRS with respect to that year, without regard to whether any particular subsidiary has subsequently left the group.

Under the Treasury Regulations applicable to consolidated returns, consolidated taxable income is computed by combining

the separate income and loss of each member. Taxable income of profitable members is offset currently by losses of other members. Only the *overall* group NOL is carried back or forward. Fixed arithmetic rules are provided to apportion the consolidated NOL carryover among the members in the event one of them leaves the group, for example by the issuance of stock to creditors in a bankruptcy proceeding; however, temporary Regulations issued on March 9, 1990, give a parent corporation an election under certain circumstances to "reattribute" to the parent all or a portion of the NOL carryover that would otherwise be apportioned to and leave the group along with a departing member.

Each corporation that is a member of a group during *any part* of a year for which a consolidated return is filed is severally liable for the *entire* group's Federal income tax for that *entire* year, regardless of that member's income or loss for the year and regardless of any intercompany agreements regarding the allocation of tax liability. Although no agreement entered into among members of a group can reduce the several liability of a member for the group's entire tax, it is nevertheless important for many purposes to determine a member's *share* of the group's liability for a taxable year. Computation of a member's share of tax liability is crucial in determining each member's separate company "earnings and profits," which may be of significance in characterizing distributions by it and in applying the consolidated return rules designed to avoid double taxation within an affiliated group. Such a computation is also relevant in determining claims of a subsidiary's creditors or minority shareholders who are concerned that a member pay no more than its fair share (and receive any tax-sharing payments to which it is entitled).

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The tax law prescribes several methods of allocating a group's tax liability for the limited purpose of computing the earnings and profits of each member of the group. Among the alternative elective methods is one which permits, where income of some members is being sheltered with the losses of others, (a) allocating to members with taxable income an additional liability equal to all or part of the excess of what their separate tax liabilities would have been over their shares of the actual liability of the group and (b) crediting that excess of the members "contributing" losses to the group.

It is important to bear in mind that this allocation of tax liability for earnings and profits purposes, which may be effected by an election made by the group (acting through its agent, the common parent), has no impact on the rights of a member to compel the contribution by another member of its share of the tax liability (and certainly does not require payment to a member whose losses have reduced the overall liability of the group, even if the method described in of the preceding paragraph has been elected). While such an obligation may arise by agreement or under general equitable principles, the tax law does no more than provide that a failure to pay the amount determined under the allocation method used by the group "will generally be treated [for tax purposes] as a distribution with respect to stock, a contribution to capital, or a combination thereof, as the case may be."

WHAT HAPPENS IN BANKRUPTCY?

All these tax rules fit together more or less well. Unfortunately, the attempt to overlay them on creditors' rights and bankruptcy law concepts, such as "fraudulent transfer" and "property of the estate," has resulted in almost forty years of

confusion culminating in the Bankruptcy Court's recent opinions in *Prudential Lines*.

Prior Cases

No decided cases -- whether inside or outside of bankruptcy -- appears to have held that an affiliate included in a consolidated return is, absent an agreement, *obligated* to pay for its use of another member's current losses or share of the group's NOL carryover. Some cases have gone so far as to appear to prohibit any such payments, even if there is an agreement. On the other hand, in *In re Koscot Interplanetary, Inc.*, 37 A.F.T.R.2d (P-H) 76-1470 (M.D. Fla. 1976), a case dismissed on procedural grounds, the court seemed prepared to require a bankrupt debtor's affiliates to pay for use of the debtor's net operating losses on fraudulent conveyance grounds, where the debtor was insolvent when the consolidated return claiming use of those losses was filed, and the weight of authority certainly seems to *permit* consensual payments by testing them under the liberal "business judgment" rule.

Any obligation to pay for the use of losses must be distinguished from the requirement that a parent, which receives a refund attributable to taxes previously paid by a subsidiary on its own earnings, return the refund to the bankrupt subsidiary. *In re Bob Richards Chrysler Plymouth Corp.*, 473 F.2d 262 (9th Cir.), *cert. denied*, 412 U.S. 919 (1973). In 1988, section 6402(i) was added to the IRC; this new section codifies and may expand the *Bob Richards* rule by authorizing the IRS to pay a refund to the fiduciary of an insolvent subsidiary to the extent the refund is "properly attributable" to the losses of the subsidiary and payment to the fiduciary is consistent with the purposes of the consolidated return rules.

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Prudential Lines

Prudential Lines, Inc. ("PLI") was a bankrupt corporation in chapter 11 proceedings with a $74,000,000 NOL carryover. Its parent, "PSS," intended to claim a worthless stock deduction with respect to its PLI stock for the 1988 tax year. This would have triggered an ownership change of PLI, which would have effectively eliminated the future utility of PLI's net operating loss, by subjecting it to severe restrictions under IRC section 382.

A proposed plan of reorganization of PLI called for its creditors to receive notes due in five years. PLI's NOL carryover was expected to enhance recovery to creditors by reducing tax liabilities and thereby enabling payment of the notes ahead of schedule. PLI's creditors sought to enjoin PSS from claiming its worthless stock deduction, on the grounds that PLI's NOL carryover was "property" of PLI's estate and that PSS's taking of a worthless deduction would be an exercise of control over such property precluded by the automatic stay.

The court agreed with the creditors' contentions. In reaching its conclusion, the court relied on cases under the Bankruptcy Code indicating that "property" subject to the automatic stay was intended to be interpreted broadly. The court also relied on *Segal v. Rochelle*, 382 U.S. 375 (1966), in which tax refund claims attributable to NOL *carrybacks* were held to be property of the bankrupt's estate. The bankruptcy court found the preservation of NOLs for future use to be analogous to the *Segal* refund claims.

PSS argued that recognizing NOL carryovers as "property" could mean that fraudulent transfer rules would apply where, for example, a *pre-bankruptcy* tax savings have been achieved

through the filing of a consolidated return or where a shareholder has taken a pre-bankruptcy worthless stock deduction. The court did not decide this issue. It noted, however, that, if fraudulent transfer rules were to apply, it would be through an "intended detriment to creditors or the failure of a debtor to receive reasonably equivalent consideration while insolvent" -- in other words, "constructive fraud." Yet, in the case of a worthless stock deduction, the court suggested (without offering any reason) that reasonably equivalent consideration for taking such a deduction might be found. In addition, the court appeared to believe that a fraudulent transfer issue with respect to a worthless stock deduction was unlikely ever to arise, since the deduction may only be taken when the stock is truly worthless and, in the court's view at least, stock can only be truly worthless if the corporation is about to be liquidated, whereupon the NOL carryover would be lost in any event. This is a strange position to take in light of the facts of the case before the court, in which the debtor's *old* stock may have become worthless in the chapter 11 reorganization, but the debtor's corporate existence continued.

With respect to whether taking a worthless stock deduction amounted to an "exercise of control" over the debtor's NOL, the court noted that one of the purposes of the stay was to prevent dismemberment of the bankrupt's estate. The claiming of a worthless stock deduction would violate this purpose because it "dismembers the estate by eliminating a potential [i.e., the NOL carryover] that may be of benefit to creditors." Thus, the court enjoined PSS from taking a worthless stock deduction.

Prudential Lines is disturbing to tax practitioners for several reasons. First, the holding that a net operating loss is property

-- rather than a mere inchoate right or potential to reduce future taxes, if, as, and when taxable income is generated in the future -- seems erroneous. In any event, reliance by the bankruptcy court on cases dealing with tax refunds due to the carryback of a net operating loss, like *Segal* and *Bob Richards*, seems misplaced. The future tax benefits of an NOL are entirely speculative because they depend on the taxpayer's realizing net income in future years. These potential benefits are fundamentally different from the right to a *refund* attributable to the carry*back* of an NOL.

In the refund case, the income to be offset by the carryback has already been earned and, perhaps even more important, the taxpayer's right to the refund has been established and constitutes a fixed claim against the taxing authority. Thus, under IRC section 6402(i), in the case of an insolvent corporation which is a member of an affiliated group and which is subject to a statutory or court-appointed fiduciary, any refund attributable to losses of the insolvent corporation may be paid on behalf of the insolvent corporation to its fiduciary. Depending on how that section is administered by the IRS (and we understand that one possibility currently being considered by the IRS is to restrict its application to insolvent financial institutions), section 6402(i) may, in limited circumstances, have the effect of expanding the right of a loss subsidiary to be paid for the *actual* use of its losses by other members of the group, but the section also comports with the notion that it is a *refund* (or a claim for a refund) which is a property right, not the right to carry net operating losses forward. Furthermore, the appropriate amount to be paid for use of NOLs is speculative, because of uncertainties regarding when and whether the debtor will ever be able to use the NOL, either because of a lack of future income or because of section 382 or other restrictions imposed by the IRC.

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The *Prudential Lines* opinion also implies that a profitable member of a consolidated group may be required to compensate a loss member for the *pre-filing* use of the loss member's losses, even though the automatic stay has no application to pre-filing periods; the court suggests that, if payment is not made and the loss member becomes bankrupt, the losses will have been fraudulently appropriated by the profitable member. This goes well beyond the holding of *Bob Richards* and any rational application of section 6402(i). It also runs counter to the weight of prior cases and general principles of tax law, which generally do not compel "the conclusion that a tax saving must or should inure to the benefit of the parent company or the company which sustained the loss that makes possible the tax saving." *Bob Richards*, quoting the seminal case of *Western Pac. R.R. v. Western Pac. R. Co.*, 197 F.2d 994, 1004 (9th Cir. 1951), *rev'd on other grounds*, 345 U.S. 247 (1953).

Similarly, the decision in *Prudential Lines* is disturbing in its disregard for the need of members of the debtor's affiliated group to be able to proceed with their tax filings in a proper manner. For example, the court issued an injunction which delayed the filing of PSS's 1988 return beyond any extension of its due date which might have been granted by the IRS. Consider also the court's treatment of the rules regarding when a taxpayer may take a worthless stock deduction. In granting a permanent injunction against PSS's taking a worthless stock deduction for 1988, the court noted that PSS had not advanced any reason why it could not claim a worthless stock deduction in a taxable year *after* 1988, when it would no longer be (or might not be) a "50% shareholder." The court's reasoning ignores the rule that, in order to obtain a loss deduction with respect to worthless stock (whether or not sold or otherwise disposed of), a taxpayer must prove that the stock was worthless

in the year claimed and that the stock was not worthless in a prior year. Because the court seemed so to misunderstand the tax rules, it is difficult to know how it would balance the tax policy of allowing a worthless stock deduction to a parent corporation which has incurred a true economic loss against the articulated bankruptcy policy of preserving the debtor's NOL carryovers.

Other Implications

The court's reliance on concepts of "property of the estate" would seem on its face to prohibit a parent corporation of a bankrupt debtor which leaves the affiliated group as a result of a chapter 11 reorganization from electing a "reattribute" to itself the portion of the consolidated NOL carryover that would otherwise be apportioned to the debtor. Even though the tax return on which the parent would make such an election would in many cases be filed after conclusion of the bankruptcy proceeding, *Prudential Lines* holds that the automatic stay and the bankruptcy court's continuing jurisdiction can be used to prohibit such conduct as well.

In the bankruptcy context, then, *Prudential Lines* seems to have broad tax ramifications. Even as limited to NOL carryforwards, the decision may limit the choices a common parent corporation, as agent of the group, may have to make various elections that might affect the size of a subsidiary's share of a consolidated NOL (e.g., elections to capitalize certain expenses or, in connection with a debt restructuring, to reduce the tax basis of assets, rather than NOL carryovers). The court's reasoning may even embolden a court to stay *creditors'* transfers of certain claims (whether consisting of "trade debt" or of bonds and debentures), if such transfers might limit the ability of the debtor corporation to qualify for one of the

bankruptcy exceptions to the limitations of IRC section 382, which requires that at least 50% of the stock of the reorganized debtor be held by some combination of "old and cold" creditors (i.e., creditors who have held their claims since they arose or for at least 18 months prior to the debtor's chapter 11 filing) and former shareholders of the debtor.

CONCLUSION

By relying on the automatic stay provisions, rather than on general equitable principles governing fiduciary duties and corporate parent-subsidiary relationships, the law of fraudulent conveyances, or statutory or nonstatutory sources of Federal income tax law, *Prudential Lines* may actually discourage the use of the bankruptcy process to reorganize troubled debtors, because of the lessened flexibility, relative to an out-of-court-workout, that the debtor's affiliates may now have in structuring their income tax liabilities. This would be an ironic development in light of the IRC's equation for certain purposes of the tax consequences of bankruptcy and out-of-court workouts, which was aimed (according to the legislative history of the Bankruptcy Tax Act of 1980) at *not* forcing troubled debtors into bankruptcy court so as to obtain *favored* tax treatment.

APPENDIX F

11 U.S.C. § 346

(a) Except to the extent otherwise provided in this section, subsections (b), (c), (d), (e), (g), (h), (i), and (j) of this section apply nothwithstanding any State or local law imposing a tax, but subject to the Internal Revenue Code of 1954 (26 U.S.C. 1 et seq.)

* * *

(i)(1) In a case under chapter 7, 12 or 11 of this title concerning an individual, the estate shall succeed to the debtor's tax attributes, including --

(A) any investment credit carryover;
(B) any recovery exclusion;
(C) any loss carryover;
(D) any foreign tax credit carryover;
(E) any capital loss carryover; and
(F) any claim of right.

APPENDIX G

11 U.S.C. § 362

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of --

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debt or that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

APPENDIX H

11 U.S.C. § 541

§ 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, whereover located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is --

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) Any interest in property that would have been property of the state if such interest had been an interest

of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date --

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an indivdual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

(b) Property of the estate does not include--

(1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor;

(2) any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the case under this title, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case; or

(3) any eligibility of the debtor to participate in programs authorized under the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.; 42 U.S.C. 2751 et seq.), or any accreditation status or State licensure of the debtor as an educational institution.

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law--

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable underapplicable nonbankruptcy law is enforceable in a case under this title.

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate

under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

APPENDIX I

26 U.S.C. § 165

§ 165. Losses

* * *

(g) Worthless securities.--

(1) General rule.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2)

No. 90-1943

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

IN RE PRUDENTIAL LINES, INC.,
Debtor.

PSS STEAMSHIP COMPANY, INC.,
Petitioner,

v.

THE OFFICIAL COMMITTEE OF
UNSECURED CREDITORS,

and

COLD SPRING SHIPPING, L.P.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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QUESTIONS PRESENTED

1. Whether a net operating loss generated by a corporate debtor in its pre-petition operations is "property" of the debtor's bankruptcy estate within the meaning of section 541 of the Bankruptcy Code and therefore protected by the automatic stay.

2. Whether it was proper for the Bankruptcy Court to enjoin petitioner from taking a worthless-stock deduction for tax year 1988, when that deduction, if ever taken for that year, would effectively eliminate the debtor's net operating loss.

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IN THE

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OCTOBER TERM, 1991

No. 90-1943

IN RE PRUDENTIAL LINES, INC.,
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---

BRIEF OF RESPONDENTS IN OPPOSITION

STATUTES INVOLVED

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11 U.S.C. § 362—Petitioner's Appendix (P. App.) 82a

11 U.S.C. § 541—P. App. 84a

26 U.S.C. § 382—R. App. 4a

STATEMENT

The issue in this case is whether a valuable asset of a corporate debtor, a net operating loss ("NOL") attributable to losses generated by the debtor in its pre-bankruptcy operations, belongs to the debtor's sole stockholder, the petitioner here, or to the debtor for the benefit of its creditors, as common sense suggests and the court of appeals ruled.

Prudential Lines, Inc. ("PLI" or the "debtor") was at all relevant times a wholly owned subsidiary of petitioner PSS Steamship Company, Inc. PLI operated as a United States flag shipping company with offices in major United States, European, and Middle Eastern ports. Petitioner was a member of an affiliated group for federal income tax purposes that included PLI. The affiliated group had filed consolidated federal income tax returns since 1976.

On September 12, 1986, an involuntary Chapter 11 petition was filed against PLI in the United States Bankruptcy Court for the Southern District of New York; PLI subsequently consented to an order for relief. Respondent Official Committee of Unsecured Creditors (the "Committee") is a committee established pursuant to 11 U.S.C. § 1102 to represent the interests of unsecured creditors in the PLI bankruptcy case. Respondent Cold Spring Shipping, L.P. ("Cold Spring") is a limited partnership that held a participation interest in a large unsecured claim in the PLI bankruptcy case.[1]

After the debtor was unsuccessful in garnering support for its own plan of reorganization, respondents submitted a joint plan of reorganization for creditor approval in mid-1989.[2] One asset important to the reor-

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[1] Respondents are not corporations, and therefore there are no parent companies or subsidiaries to be disclosed pursuant to Rule 29.1 of the Rules of this Court.

[2] On December 15, 1989, the joint plan was confirmed by the bankruptcy court. Pursuant to the joint plan, the stock of the

ganization of the debtor was the debtor's approximately $74 million NOL, generated by the debtor's pre-petition operations. It is undisputed that this NOL would, but for the steps threatened by petitioner as described in the following paragraph, be available to the reorganized debtor.

In November 1989, as the creditors were about to vote on the joint plan, petitioner announced its intention to file a federal income tax return for 1988 claiming a worthless-stock deduction with respect to its ownership of all the stock of the debtor. It is undisputed that petitioner's taking of the worthless-stock deduction would have effectively eliminated the debtor's NOL.[3] Nonethe-

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reorganized debtor was issued to creditors (or to a trust for the benefit of creditors) and the reorganized debtor ceased to be a member of the affiliated group for federal income tax purposes.

[3] Under section 382 of the Internal Revenue Code, 26 U.S.C. § 382 (1988), a "change of ownership" of a corporation results in an annual limitation on the corporation's NOL generally equal to the value of the corporation's stock before the ownership change times a prescribed rate of return. Under Section 382(g)(4)(D) of the Internal Revenue Code, an ownership change is deemed to occur on the last day of the tax year in which a majority shareholder declares its stock in a corporation to be worthless by claiming a worthless-stock deduction. Thus, petitioner, by claiming a worthless-stock deduction for tax year 1988 would have triggered a deemed ownership change on December 31, 1988, and would have effectively eliminated PLI's NOL as of that date. *See* P. App. at 45a n.2, 63a-64a n.18 (bankruptcy court's explanation).

Section 382(g)(4)(D) is intended to preclude a corporate shareholder from claiming that a subsidiary corporation is worthless and later (directly or indirectly) enjoying the use of the subsidiary corporation's NOL. Ways and Means Committee Report on H.R. 3545, 100th Cong., 1st Sess. 1096 (1987). Petitioner's worthless-stock deduction would not have affected the debtor's NOL if the deduction were taken in any year other than 1988. Section 382(g)(4)(D) does not apply to tax years prior to 1988. Nor would section 382(g)(4)(D) apply if petitioner took its worthless-stock deduction in 1989, the year in which the joint plan of reorganization was confirmed. Section 382(g)(4)(D) applies only where the majority shareholder holds the stock at the close of its taxable year. PLI stock passed to PLI creditors at the time of confirma-

less, petitioner never moved for relief from the application of the automatic stay.

On November 13, 1989, to prevent petitioner from eliminating the NOL available to the debtor's creditors in the plan of reorganization, respondents filed an adversary complaint against petitioner in bankruptcy court seeking declaratory and injunctive relief. The pertinent count of the complaint asserted that petitioner's threatened action would violate the automatic stay provision, 11 U.S.C. § 362, because it would destroy property of the debtor's bankruptcy estate, namely PLI's NOL.[4]

On November 13, 1989, the bankruptcy court granted a temporary restraining order against the petitioner. After a day-long evidentiary hearing, on December 4, 1989, the bankruptcy court granted a preliminary injunction, holding that the debtor's NOL, attributable to the pre-bankruptcy operations of the debtor, was property of the bankruptcy estate protected by the automatic stay. P. App. 41a. On December 19, 1989, four days after the confirmation of the joint plan, the bankruptcy court issued a second opinion explaining the scope and nature of the injunction: the court permanently enjoined petitioner from taking a worthless-stock deduction for tax year 1988 but did not prohibit petitioner from taking the deduction in any other year. P. App. 31a.

Petitioner appealed to the district court. On September 28, 1990, the district court entered an order affirming

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tion of the joint plan in December 1989 and therefore, a worthless-stock deduction in that tax year would not have had adverse repercussions for the debtor under section 382(g)(4)(D).

[4] Two other counts of the complaint alleged that petitioner's threatened action would violate the fiduciary duty it owed to its insolvent subsidiary, PLI, and to PLI's creditors, and that petitioner's proposed action was in bad faith. The bankruptcy court denied relief on these counts; respondents cross-appealed from this ruling, but neither the district court nor the court of appeals reached the merits of these claims.

the bankruptcy court's entry of a permanent injunction. P. App. 23a.

On March 20, 1991, a unanimous panel of the Court of Appeals for the Second Circuit affirmed the district court's ruling. P. App. 1a. The Second Circuit held, first, that the debtor's NOL was property of the bankruptcy estate within the meaning of 11 U.S.C. § 541, protected by the automatic stay, 11 U.S.C. § 362. The Second Circuit then held that it was proper for the bankruptcy court to enjoin petitioner permanently, pursuant to 11 U.S.C. § 105, from taking a worthless-stock deduction for tax year 1988, in order to prevent destruction of an asset of the estate, the loss of which would impede the debtor's reorganization.

ARGUMENT

I. THE SECOND CIRCUIT'S RULING THAT THE DEBTOR'S NET OPERATING LOSS WAS PROPERTY OF THE BANKRUPTCY ESTATE WAS A STRAIGHTFORWARD AND CORRECT APPLICATION OF SECTION 541 OF THE BANKRUPTCY CODE, DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR ANY OTHER COURT OF APPEALS, AND PRESENTS NO ISSUE MERITING REVIEW.

The court of appeals correctly ruled that a net operating loss—whether a carryback or a carryforward [5]—is property of the corporate debtor. Tax law and bankruptcy law together make it clear that a corporate debtor's NOL belongs to the corporate debtor during and after its reorganization under Chapter 11.

The court of appeals recognized that "[t]he nature and extent of the debtor's interest in property is determined by applicable non-bankruptcy law" but that "[w]hether

[5] Generally, net operating losses of a corporation may be carried back three years and carried forward fifteen years to offset otherwise taxable income. 26 U.S.C. § 172(b) (1988).

that interest is included in the property of the debtor's estate is determined by bankruptcy law." P. App. 9a (citations omitted). Using this analytical framework, the court of appeals first addressed the question whether the debtor had an interest in the NOL generated by its own operations and correctly concluded that "at the commencement of the bankruptcy case against it, PLI had an interest in the $74 million NOL attributable to its pre-bankruptcy operation." P. App. 13a.

The tax law and regulations thereunder are clear in providing that, in a bankruptcy proceeding like the present case, a corporate debtor's interest in its NOL is not only retained by the debtor but should be preserved for the benefit of the creditors. In this case, both the petitioner's and respondents' plans of reorganization proposed during the bankruptcy proceeding would have resulted in PLI's ceasing to be owned by PSS and thereby ceasing to be a member of the affiliated group for tax purposes. In fact, the certainty of this disaffiliation was essential to petitioner's worthless-stock claim.[6] The regulations for affiliated groups, however, clearly provide that when a subsidiary leaves an affiliated group, the subsidiary's portion of the aggregate NOL of the affiliated group is retained by the former subsidiary and is not allocated to its parent or to other members of the consolidated group.[7]

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[6] The IRS has ruled that where there are prospects for reorganization of the debtor, a worthless-stock deduction may not be claimed until there is no reasonable prospect that the shareholder will be allocated any stock of the reorganized debtor. Rev. Rul. 77-17, 1977-1 C.B. 44, 46, *citing Lawson v. Commissioner*, 42 B.T.A. 1103 (1940), *acq.*, 1940-1 C.B. 7.

[7] Contrary to petitioner's contention, tax law makes it clear that, in the circumstances of the present case, an NOL carryforward belongs to the corporation that has generated the NOL, not to its corporate parent. When a subsidiary leaves a consolidated group, the subsidiary's portion of the consolidated group's NOL carryovers at the time of its departure belongs to the subsidiary, not to its parent or to other members of the consolidated group. Treas. Reg. § 1.1502-79(a)(1)(ii) (Proposed rule change

Thus, PLI clearly had a valuable continuing interest in the NOL.

It is also clear that Congress intended that in a qualified bankruptcy reorganization a corporate debtor's NOL would be retained by the reorganized debtor for the specific benefit of the creditors. The reorganization plan proposed by respondents and confirmed by the bankruptcy court was designed to qualify under the special bankruptcy reorganization exception to the normal NOL limitations following an ownership change. Under this statutory exception, section 382(*l*)(5) of the Internal Revenue Code,[8] the NOL of a corporate debtor is retained by the reorganized debtor, subject to certain reductions, for the benefit of the reorganized debtor and its creditors.[9] The

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published at 49 Fed. Reg. 30536 (July 31, 1984) would redesignate subsection (1)(ii) as (1)(iii).). During a bankruptcy proceeding where potential reorganization plans would result in a debtor-subsidiary's leaving a consolidated group because the old equity owners do not retain 80 percent ownership, the debtor-subsidiary has a valuable future interest in its own NOL carryforwards pursuant to this allocation rule.

On March 14, 1990, the IRS issued proposed regulations that would prohibit a parent corporation from recognizing a loss on the disposition of subsidiary stock. Those regulations provide a special rule that would permit a parent corporation to reattribute a subsidiary's NOLs back to the parent to the extent such loss was disallowed. 55 Fed. Reg. 9426 (1990). On November 19, 1990, the IRS clarified that under this reattribution rule, the "[l]osses of a subsidiary may not be reattributed . . . to the extent that the subsidiary . . . [is] insolvent . . . at the time of the disposition." Prop. Treas. Reg. § 1.1502-20(g)(2) in 55 Fed. Reg. 49075, 49088 (1990). In making this clarification, the IRS expressly provided that "[t]o the extent of its insolvency, *the subsidiary's losses are not reattributable because they are deemed to be borne by creditors.*" 55 Fed. Reg. at 49082 (emphasis added).

[8] 26 U.S.C. § 382(l)(5) (Supp. 1990).

[9] In legislative history of section 382(*l*)(5) it was noted:

> Under the general rule of the Act, no carryforwards would be usable after the acquisition of an insolvent corporation

court of appeals thus correctly concluded that PLI had an interest in the NOL attributable to its own operations.

The court next considered whether such an interest was "property" within the meaning of the Bankruptcy Code and concluded that it was. This conclusion is also plainly correct. Section 541 of the Bankruptcy Code provides that the bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1), P. App. 84a. The court of appeals recognized that "[i]n construing this section, . . . Congress intended § 541 to be interpreted broadly," citing this Court's decision in *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 (1983), P. App. 8a-9a.[10] Consistently with the breadth of

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> because the corporation's value immediately before the acquisition would be zero. In such a case, however, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders. Relief from a strict application of the general rule is provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward.

JCS-10-87, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 299 (May 4, 1987) (citation omitted).

[10] In defining "property" as it did in the Bankruptcy Code, Congress intended to "bring anything of value that the debtors have into the estate." H.R. Rep. No. 595, 95th Cong., 1st Sess. 176 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6136. The House Report commented:

> This includes all interests, such as interests in real or personal property, tangible and intangible property, choses in action, causes of action, rights such as copyrights, trade-marks, patents, and processes, contingent interests and future interests, whether or not transferable by the debtor.

Id. at 175-76. The Senate Report indicated that "property" under the Code was to be even broader than the definition under the predecessor Bankruptcy Act:

> The scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified

the Bankruptcy Code's definition of property, courts have had no reluctance to hold that various intangible and contingent rights are property of the bankruptcy estate.[11] The court of appeals' conclusion that "[t]he speculative nature of carryforwards does not place them outside the definition of property of the estate" (P. App. 15a.) is consistent with the breadth of the statutory definition and with case law interpreting the statute.

Petitioner argues that *Segal v. Rochelle*, 382 U.S. 375 (1966), and its codification in the Bankruptcy Code somehow imply that an NOL carryforward is not property of the bankruptcy estate of a corporate debtor. They do nothing of the kind. To the extent that *Segal* is relevant to the present case, it is entirely consistent with the holding of the court of appeals.

In *Segal*, decided under the Bankruptcy Act, this Court held that a net operating loss carry*back was* "property of the estate" of a bankrupt *individual.* This Court based its decision in *Segal* on the "thrust of § 70a(5) [the provision defining property in the Bankruptcy Act, predecessor of section 541 of the Bankruptcy Code] . . . to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition

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> in section 70a of the Bankruptcy Act § 70a, as well as property recovered by the trustee under section 542 of proposed Title 11. . . .

S. Rep. No. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5868.

[11] *See In re Gull Air, Inc.*, 890 F.2d 1255 (1st Cir. 1989) (gate slot is property); *In re Fugazy Express, Inc.*, 114 Bankr. 865 (Bankr. S.D.N.Y. 1990) (FCC license was property of estate), *aff'd*, 124 Bankr. 426 (S.D.N.Y. 1991); *In re Brown Transport Truckload, Inc.*, 118 Bankr. 889 (Bankr. N.D. Ga. 1990) (state grant of operating authority was property of estate); *In re McClain Airlines, Inc.*, 80 Bankr. 175 (Bankr. D. Ariz. 1987) (gate slot was property of estate); *see also In re Colonial Realty Co.*, 122 Bankr. 1 (Bankr. D. Conn. 1990) (debtor's property management agreement was property of estate).

. . . . [A]n interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed." 382 U.S. at 379.

Segal stopped short of holding that loss carry*forwards* were also property of the bankruptcy estate of an *individual.* The Court said "a carryover into post-bankruptcy years can be distinguished conceptually as well as practically" from a carryback because of the "inconvenience and hindrance [that] might be caused for the bankrupt individual" in keeping open the estate for the possible carryover period. 382 U.S. at 381. The Court did not discuss NOLs of a *corporate* debtor, and there is no reason to believe that the Court would have had any misgivings about treating carryforwards as property of a corporate debtor.

The bankruptcy estate of an individual was, under the Bankruptcy Act, and still is, under the Code, a taxable entity separate from the individual bankrupt, 11 U.S.C. § 346(b)(1) (1988), and the policy of the bankruptcy law was and is to give an individual a "fresh start." Since the value of carryforwards can only be determined with the passage of time, it would be necessary to keep the estate open to see what value the carryforwards would have to the estate. As the Court noted in *Segal,* keeping a bankruptcy case open in order to realize the value of carryforwards would necessarily delay settlement of the debtor's affairs and implementation of the discharge provisions that provide the individual debtor with his "fresh start." As the court of appeals noted here, "[t]o address the *Segal* Court's concern that including carryforwards as property of the estate would jeopardize the fresh start policy, Congress provided [in the Bankruptcy Code] that unutilized tax attributes revert to the debtor at the conclusion of the case. 11 U.S.C. § 346(i)(2) (1988)." P. App. 16a-17a.

None of this is applicable to corporate debtors. While the fresh start policy is important for the individual

debtor, affording the debtor "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt," *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934), it is well established that the "fresh start policy does not apply to corporations." [12] For a corporation, "there is no comparable distinction between 'existing' and 'future' assets either in theory or in practice." [13] The bankruptcy estate of a corporate debtor is *not* a separate entity for tax purposes. A corporation remains the same taxable entity before, during, and after a bankruptcy proceeding. Thus, the estate does not have to remain open in order to realize the value of the carryforwards, because the corporations may use them during or after the bankruptcy, with the same resultant value to creditors.

Accordingly, all rulings since *Segal* have been consistent with the principal that net operating loss carryforwards of a corporation can be property of the estate under the Bankruptcy Act and the Bankruptcy Code. For example, the Eighth Circuit, in a case decided under current bankruptcy law, recently held that a net operating loss carryforward is property of the bankruptcy estate. *In re Russell*, 927 F.2d 413, 417-18 (8th Cir. 1991).[14]

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[12] Note, *Bankruptcy and the Union's Bargain: Equitable Treatment of Collective Bargaining Agreements*, 39 Stan. L. Rev. 1015, 1025 n.67 (1987).

[13] Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 110 n.45 (1984).

[14] *See also In re Beery*, 116 Bankr. 808 (D. Kan. 1990) (holding that, in light of *Segal v. Rochelle* and the circumstances of the case, a net operating loss carryforward was property of an individual's bankruptcy estate under the Bankruptcy Act); *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262, 264 (9th Cir.), *cert. denied*, 412 U.S. 919 (1973) ("[A]t the date of the filing of the petition in bankruptcy, [a] Trustee acquire[s] any interest the bankrupt ha[s] in the carryback tax refund," *citing Segal v. Rochelle*); *In re Koscot Interplanetary, Inc.*, 76-1

Petitioner next argues that in enacting the Bankruptcy Code, Congress determined that an NOL should be considered property of the estate of an individual debtor but not of a corporate debtor. Petitioner bases this conclusion on its examination of section 346(i)(1)(c) of the Bankruptcy Code, which expressly provides that in a case involving an individual, the estate succeeds to the debtor's tax attributes, including "any loss carryover." 11 U.S.C. § 346 (Supp. 1990). Because section 346(i) applies only to individual debtors, petitioner argues that Congress intended to bar the estates of corporate debtors from similarly succeeding to loss carryovers.

But as the court of appeals noted, two other subsections of section 346, sections 346(h) and (j), "contemplate use of NOL carryforwards by a corporate debtor." P. App. 17a. Section 346(h) discusses the determination of periods in which any debtor may use "a loss carryover or a loss carryback." Section 346(j) limits the use that debtors—corporate or individual—may make of NOLs by providing that "any net operating loss *of an individual or corporate debtor, including a net operating loss carryover to such debtor*, shall be reduced by the amount of indebtedness forgiven or discharged . . . ." 11 U.S.C. § 346(j)(3) (1988) (emphasis added). It could hardly be clearer that the Bankruptcy Code contemplates that NOL carrybacks and carryforwards are property of the estate of a corporate debtor.[15]

U.S.T.C. (CCH) ¶ 9442, at 84,186 (M.D. Fla. 1976) ("[*S*]*uch 'net operating loss' could qualify as a 'property' within the meaning of Sec. 70(a) of the Bankruptcy Act*").

[15] PSS misreads *Davis v. Commissioner*, 69 T.C. 814 (1978), as support for its position when, in fact, the case includes language quite contrary to petitioner's argument. Under the rationale of *Segal*, the Tax Court in *Davis* agreed that the NOLs did not become property of the estate of the individual debtors under the Bankruptcy Act, but remained with the individual debtors. What is important to this case is the Tax Court's observation:

> We recognize that net operating losses of corporations may be transferred and absorbed by successor corporations under

Petitioner also argues that an NOL is not the property of the debtor whose operations have generated the NOL but of the parent company that is responsible for filing the consolidated federal income tax return for the affiliated group and, in ordinary circumstances, decides how all NOLs of members of the affiliated group will be used. The court of appeals properly rejected this attempt to seize a valuable asset for the benefit of the debtor's stockholder rather than the debtor's creditors:

> The fact that a subsidiary's NOL ultimately may be used to offset another corportion's income does not mean that the subsidiary loses any interest in its NOL. The common parent acts as an agent on behalf of all the members of the consolidated group "for the convenience and protection of [the] IRS only." . . . [T]he property interests of the subsidiaries are not absorbed by the common parent. . . . It follows that a corporation does not lose any interest it had in the right to use its NOL to offset income because of its status in a group of affiliated corporations that file a consolidated tax return.

P. App. 12a-13a (citations omitted). And the consolidated return regulations, cited at footnote seven, *supra*, make it clear that when consolidation is broken, a departing subsidiary takes its share of the NOL with it.

Petitioner cites cases discussing a company's obligation to pay compensation to an affiliated company that generated an NOL that is used to offset the first com-

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limited circumstances (secs. 269, 381, and 382), but Congress has not seen fit to provide for the transfers of net operating losses by or to individuals.

69 T.C. at 830.

Thus, even *Davis*, upon which Petitioner erroneously relies to support its argument, indicates the long-standing policy of tax and bankruptcy law, working together, that allows a corporation reorganized in bankruptcy to retain its NOLs.

pany's income on a consolidated return.[16] As the Second Circuit said, these cases "stand for the proposition that one member of an affiliated group does not [in the absence of intercompany contract] have to compensate another member for tax benefits accruing to it through the use of the other member's NOL." P. App. 11a. The court of appeals properly rejected the application of these cases to the present case on the ground that they were decided "under fiduciary duty and contract standards," *Id.*, and "none purported to determine whether the NOL attributable to the bankrupt corporation was property of that corporation's bankruptcy estate." P. App. 12a.[17]

In sum, the court of appeals' holding that PLI's NOL is property of the corporate bankruptcy estate was correct, is entirely consistent with the decisions of this Court in *Segal* and *Whiting Pools* and with lower court decisions interpreting section 541 of the Bankruptcy Code.

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[16] PSS cites or discusses *Western Pac. R.R. Corp. v. Western Pac. R.R. Co.*, 197 F.2d 994 (9th Cir. 1951), *vacated and remanded on other grounds*, 345 US. 247, *reh'g denied* 206 F.2d 495 (9th Cir.), *cert. denied*, 346 U.S. 910 (1953); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967); *Case v. New York Cent. R.R.*, 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965); *Jump v. Manchester Life & Casualty Management Corp.*, 438 F. Supp. 185 (E.D. Mo. 1977), *aff'd*, 579 F.2d 449 (8th Cir. 1978); *In re Coral Petroleum, Inc.*, 60 Bankr. 377 (Bankr. S.D. Tex. 1986); *M & M Transp. Co. v. U.S. Indus., Inc.*, 416 F. Supp. 865 (S.D.N.Y. 1976); *In re All Prods. Co.*, 32 Bankr. 811 (Bankr. E.D. Mich. 1983).

[17] Petitioner also asserts, P. Br. 15-16, that its own worthless-stock deduction is not property of the bankruptcy estate. This argument is of course beside the point. The question argued and decided in the lower courts was whether the debtor's NOL was property of the bankruptcy estate.

II. THE BANKRUPTCY COURT CORRECTLY ENJOINED PETITIONER FROM EVER TAKING A WORTHLESS-STOCK DEDUCTION FOR TAX YEAR 1988, AND THE COURT OF APPEALS' AFFIRMANCE OF THAT INJUNCTION DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR ANY OTHER COURT OF APPEALS AND DOES NOT PRESENT ANY ISSUE MERITING REVIEW.

On December 19, 1989, the Bankruptcy Court permanently enjoined petitioner from taking a worthless-stock deduction for tax year 1988. The Second Circuit held that the permanent injunction was proper under section 105(a) of the Bankruptcy Code. This decision was correct and is consistent with previous decisions of this Court and other courts of appeals.

Having determined that PLI's NOL was a valuable asset which the reorganized debtor was entitled to use, the Bankruptcy Court was fully authorized to enjoin petitioner from acting in a way that would have led to the destruction of that asset, particularly since the net effect of petitioner's action would have been to place the debtor's shareholder (petitioner) ahead of its creditors. There is ample precedent for enjoining a person from an otherwise lawful action that injures property of the bankruptcy estate: "If action taken against the non-bankrupt party would inevitably have an adverse impact on property of the bankrupt estate, then such action should be barred by the automatic stay." *In re 48th Street Steakhouse, Inc.*, 835 F.2d 427, 431 (2d Cir. 1987), *cert. denied*, 486 U.S. 1035 (1988) (lessor's lease termination notice to cancel lease violated automatic stay because, if successful, termination of the lease would result in the destruction of debtor's subtenancy); *see also In re Bialac*, 712 F.2d 426 (9th Cir. 1983) (debtor's redemption interest in note, of which he owned only one-sixth interest, prevented foreclosure of the remaining five-sixths of the

note because such foreclosure would have cut off debtor's right of redemption).[18]

Petitioner's proposed deduction claim would violate the automatic stay because it could have eliminated the debtor's NOL, thus interfering with the estate's control of that property. Petitioner was correctly enjoined from seizing the value of the debtor's NOL for the debtor's sole stockholder—petitioner—and thereby denying that value to the debtor's creditors. Moreover, since the petitioner never sought relief from the automatic stay prior to the confirmation of the joint plan, this is a particularly appropriate result following the reorganization of the debtor.

As the Second Circuit noted, under section 105 of the Bankruptcy Code, a bankruptcy court has the equitable power to issue any order to carry out the provisions of the Code. This provision has been construed liberally to "enjoin [actions] that might impede the reorganization process." P. App. 21a. Numerous injunctions have been entered to prevent interference with a plan of reorgani-

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[18] In certain circumstances, bankruptcy courts will enjoin actions against nondebtor affiliates or principals of a debtor where such actions could irreparably harm the debtor's ability to reorganize. *See, e.g., In re Arrow Huss, Inc.*, 51 Bankr. 853 (Bankr. D. Utah 1985) (suits by credit card companies against debtor's principals for debts incurred on behalf of debtor enjoined for 45 days to allow principals to devote their efforts to the bankruptcy case); *In re Kasual Kreation, Inc.*, 54 Bankr. 915 (Bankr. S.D. Fla. 1985) (suits on personal guaranty by debtor's principal enjoined for 90 days where success during the Christmas season was essential to the success of the reorganization, and the time and energy of the debtor's principal would be required during that time); *In re Old Orchard Investment Co.*, 31 Bankr. 599 (W.D. Mich. 1983) (proceedings by a creditor against debtor partnership's general partner, secondarily liable for debts of partnership, were enjoined because of irreparable harm to debtor when partners are sued in their capacity as general partners: assets of general partners are part of the general fund to which all partnership creditors look to satisfy partnership debts).

zation.[19] The Second Circuit's affirmance of the bankruptcy court's decision to enjoin petitioner from taking a worthless-stock deduction for 1988, on the ground that that action would eliminate an asset of the PLI estate, was correct and does not conflict with any decision of this Court or any decision of another court of appeals.[20]

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[19] Bankruptcy courts may issue injunctions to prevent interference with a plan of reorganization. *See, e.g., Continental Illinois Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. Ry. Co.*, 294 U.S. 648, 675-79 (1935) (bankruptcy court may enjoin sale of collateral where sale would hinder, obstruct and delay the preparation and consummation of a plan of reorganization); *In re A.H. Robins Co.*, 880 F.2d 694, 701 (4th Cir.), *cert. denied*, 110 S. Ct. 376 (1989) (bankruptcy court had right to enjoin personal injury claimants from suing certain entities other than debtor so as to prevent interference with reorganization plan); *In re Johns-Manville Corp.*, 837 F.2d 89, 93 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988) (permanently enjoining actions against debtor's insurers and insurance policies when such actions "would adversely affect property of the estate and would interfere with reorganization"); *In re A.H. Robins Co.*, 788 F.2d 994, 1008 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986) (bankruptcy court enjoined suits against debtor's co-defendants because successful suits against co-defendants would diminish insurance funds pool and "thereby affect the property of the debtor to the detriment of the debtor's creditors as a whole").

[20] Petitioner alleges that the injunction prevents it from filing an "accurate" tax return. P. Br. 16. This is not so. A worthless-stock deduction is an election, to be taken at the taxpayer's option. 26 U.S.C. § 165 allows the deduction but does not require it.

Petitioner also suggests that the bankruptcy court was without authority to enjoin petitioner from taking a worthless-stock deduction in 1988 because a bankruptcy court has no jurisdiction to adjudicate tax liabilities other than those of the debtor. The Second Circuit recognized that the bankruptcy court was not adjudicating a tax liability but exercising its power "over property of the estate"—that is, over the debtor's NOL. P. App. 22a.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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August 1, 1991

APPENDICES

APPENDICES

APPENDIX A

11 U.S.C. § 105(a)

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

APPENDIX B

11 U.S.C. § 346(i)

(1) In a case under chapter 7, 12 or 11 of this title concerning an individual, the estate shall succeed to the debtor's tax attributes, including—

(A) any investment credit carryover;

(B) any recovery exclusion;

(C) any loss carryover;

(D) any foreign tax credit carryover;

(E) any capital loss carryover; and

(F) any claim of right.

(2) After such a case is closed or dismissed, the debtor shall succeed to any tax attribute to which the estate succeeded under paragraph (1) of this subsection but that was not utilized by the estate. The debtor may utilize such tax attibutes as though any applicable time limitations on such utilization by the debtor were suspended during the time during which the case was pending.

(3) In such a case, the estate may carry back any loss of the estate to a taxable period of the debtor that ended before the order for relief under such chapter the same as the debtor could have carried back such loss had the debtor incurred such loss and the case under this title had not been commenced, but the debtor may not carry back any loss of the debtor from a taxable period that ends after such order to any taxable period of the debtor that ended before such order until after the case is closed.

APPENDIX C

11 U.S.C. § 346(j)(1), (4)

(1) Except as otherwise provided in this subsection, income is not realized by the estate, the debtor, or a successor to the debtor by reason of forgiveness or discharge of indebtedness in a case under this title.

* * * *

(4) A reduction of a net operating loss or a net operating loss carryover under paragraph (3) of this subsection or of basis under paragraph (5) of this subsection is not required to the extent that the indebtedness of an individual or corporate debtor forgiven or discharged—

(A) consisted of items of a deductible nature that were not deducted by such debtor; or

(B) resulted in an expired net operating loss carryover or other deduction that—

(i) did not offset income for any taxable period; and

(ii) did not contribute to a net operating loss in or a net operating loss carryover to the taxable period during or after which such indebtedness was discharged.

APPENDIX D

26 U.S.C. §§ 382(a), (b)(1), (e)(1), (g), (l)(5)(A)

(a) General rule.—The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year.

(b) Section 382 limitation.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—

(A) the value of the old loss corporation, multiplied by

(B) the long-term tax-exempt rate.

* * * *

(e) Value of old loss corporation.—For purposes of this section—

(1) In general.—Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the ownership change.

* * * *

(g) Ownership change.—For purposes of this section—

(1) In general.—There is an ownership change if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—

(A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points over

(B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.

(2) Owner shift involving 5-percent shareholder.—There is an owner shift involving a 5-percent shareholder if—

(A) there is any change in the respective ownership of stock of a corporation, and

(B) such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change.

(3) Equity structure shift defined.—

(A) In general.—The term "equity structure shift" means any reorganization (within the meaning of section 368). Such term shall not include—

(i) any reorganization described in subparagraph (D) or (G) of section 368(a)(1) unless the requirements of section 354(b)(1) are met, and

(ii) any reorganization described in subparagraph (F) of section 368(a)(1).

(B) Taxable reorganization-type transactions, etc.—To the extent provided in regulations, the term "equity structure shift" includes taxable reorganization-type transactions, public offerings, and similar transactions.

(4) Special rules for application of subsection.—

(A) Treatment of less than 5-percent shareholders.—Except as provided in subparagraphs (B)(i) and (C), in determining whether an

ownership change has occurred, all stock owned by shareholders of a corporation who are not 5-percent shareholders of such corporation shall be treated as stock owned by 1 5-percent shareholder of such corporation.

(B) Coordination with equity structure shifts.—For purposes of determining whether an equity structure shift (or subsequent transaction) is an ownership change—

(i) Less than 5-percent shareholders.—Subparagraph (A) shall be applied separately with respect to each group of shareholders (immediately before such equity structure shift) of each corporation which was a party to the reorganization involved in such equity structure shift.

(ii) Acquisitions of stock.—Unless a different proportion is established, acquisitions of stock after such equity structure shift shall be treated as being made proportionately from all shareholders immediately before such acquisition.

(C) Coordination with other owner shifts.—Except as provided in regulations, rules similar to the rules of subparagraph (B) shall apply in determining whether there has been an owner shift involving a 5-percent shareholder and whether such shift (or subsequent transaction) results in an ownership change.

(D) Treatment of worthless stock.—If any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless during any taxable year of such shareholder and such stock is held by such shareholder as of the close of such taxable year, for purposes of determining whether an ownership change occurs

after the close of such taxable year, such shareholder—

(i) shall be treated as having acquired such stock on the 1st day of his 1st succeeding taxable year, and

(ii) shall not be treated as having owned such stock during any prior period.

For purposes of the preceding sentence, the term "50-percent shareholder" means any person owning 50 percent or more of the stock of the corporation at any time during the 3-year period ending on the last day of the taxable year with respect to which the stock was so treated.

* * * *

(*l*) Certain additional operating rules.—For purposes of this section—

* * * *

(5) Title 11 or similar case.—

(A) In general.—Subsection (a) shall not apply to any ownership change if—

(i) the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case, and

(ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears).

APPENDIX E

Treasury Regulation § 1.1502-79(a)(1)(ii)

§ 1.1502-79. Separate return years.—(a) *Carryover and carryback of consolidated net operating losses to separate return years.*—(1) *In general.*

* * * *

(ii) If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

APPENDIX F

Proposed Treasury Regulation § 1.1502-20(g)(1)-(2)

* * * *

(g) *Reattribution of subsidiary's losses to common parent*—(1) *Reattribution rule.* If a member disposes of stock of a subsidiary and the member's loss would be disallowed under paragraph (a)(1) of this section, the common parent may make an irrevocable election to reattribute to itself any irrevocable election to reattribute to itself any portion of the net operating loss carryovers and net capital loss carryovers attributable to the subsidiary (and any lower tier subsidiary) without regard to the order in which they were incurred, provided the amount reattributed does not exceed the amount that would be disallowed if an election under this pargaraph (g) were not made. The common parent succeeds to the reattributed losses as if the losses were succeeded to on the day of the disposition in a transaction to which section 381 applies. Any owner shift of the subsidiary (including any deemed owner shift resulting from section 382(g)(4)(D) or 382(l)(3)) in connection with the disposition will not be taken into account under section 382 with respect to the reattributed losses.

(2) *Insolvency limitation.* Losses of a subsidary may not be reattributed under this paragraph (g) to the extent that the subsidiary and all higher tier subsidiaries are insolvent within the meaning of section 108(d)(3) at the time of the disposition. For purposes of determining insolvency, preferred stock of a subsidiary that is not owned by members is treated as a liability to the extent of the amount of preferred distributions to which the stock would be entitled if the subsidiary were liquidated on the date of the disposition.

(3)

No. 90-1943

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1991

In re

PRUDENTIAL LINES, INC.,

Debtor.

PSS STEAMSHIP COMPANY, INC.,

Petitioner,

against

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS,

and

COLD SPRING SHIPPING, L.P.,

Respondents.

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

STATUTES INVOLVED

11 U.S.C. § 346—Petitioner's Appendix (P. App.) 81a

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26 U.S.C. § 165—P. App. 88a

26 U.S.C. § 269—Petitioner's Reply Appendix 1a

26 U.S.C. § 382—Respondent's Appendix 4a

Respondents assume the legal conclusion they wish this Court to reach by repeatedly referring to the federal tax benefit associated with the NOL carryforward here in issue as a "valuable asset" of PLI. *See, e.g.*, Brief of Respondents in Opposition at 2, 6. As discussed at length in the Petition, the consolidated return provisions of the Internal Revenue Code, 26 U.S.C. §§ 1501-1504, the regulations promulgated under them, and the cases construing them, dictate that an NOL carryforward is not an "asset" of the subsidiary that generated it, but a tax attribute of the consolidated return controlled by the corporate parent. The Bankruptcy Code does not give a bankruptcy court the power to ignore this federal tax doctrine by declaring an NOL carryforward generated by a subsidiary to be its "asset" or "property" simply because that subsidiary is under the protection of the bankruptcy court.

Respondents urge that the *Western Pacific* line of cases cited at pp. 12-15 of the Petition are inapposite because they were decided under state law and predated the broader definition of "property" in section 541 and the treatment of NOLs in section 346 of the Bankruptcy Code. Respondents assert that these two sections, when read with the section describing a bankruptcy court's general powers (11 U.S.C. § 105), provide bankruptcy courts with sufficient authority to enjoin a non-bankrupt corporate parent from taking a worthless stock deduction under 26 U.S.C. § 165 since doing so would, because of 26 U.S.C. § 382, limit the availability of an NOL carryforward generated by a

bankrupt subsidiary. Neither section 541 nor section 346 of the Bankruptcy Code, however, provides such authority, since: neither provision makes the NOL carryforward the debtor's "property," neither provision nullifies the consolidated return regulations (which allocate control of NOLs to the corporate parent even if the subsidiary that generated the NOL is in bankruptcy), and neither provision empowers a bankruptcy court to enjoin a non-bankrupt from taking a worthless stock deduction. The case should be governed entirely by the Internal Revenue Code, which recognizes *no rights whatsoever* on the part of a bankrupt subsidiary with respect either to a non-bankrupt parent's right to take the benefit of an NOL carryforward generated by a bankrupt subsidiary, or its right to take a worthless stock deduction with respect to its lost investment in that subsidiary.

Section 541. In arguing that the Court of Appeals correctly construed "property" in 11 U.S.C. § 541 to include the NOL carryforward, respondents rely on legislative history to the effect that "property" includes:

> all interests, such as interests in real or personal property, tangible and intangible property, choses in action, causes of action, rights such as copyrights, trade-marks, patents, and processes, contingent interests and future interests, whether or not transferable by the debtor.

Brief at 8 n. 7 *quoting* H.R. Rep. No. 595, 95th Cong., 1st Sess. 176 (1977), *reprinted* in 1978 U.S. Code Cong. & Admin. News 5963, 6136. Respondents also cite this Court's conclusion in *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 204-5 (1983) that section 541(a)(1)'s language ("all legal or equitable interests of the debtor in property as of the commencement of the case") is to be read broadly. If, however, Congress indeed intended NOL carryforwards (or a variety of other tax attributes) to be "property," or if it intended the Internal Revenue Code not to apply to corporate NOL carryforwards on consolidated returns once the subsidiary that generated them becomes bankrupt, why did Congress not say

so? Further, following this Court's differentiation of carryforwards and carrybacks in *Segal* v. *Rochelle*, 382 U.S. 375 (1966), why did Congress say that it was adopting *Segal* on "carrybacks," making "refunds" property of the estate, rather than say it was expanding *Segal* to cover NOL carryforwards on corporate consolidated returns? See Petition at 19 & n.13.[1] Tax attributes are not mentioned in the text of section 541, nor do they reasonably fit within the definitions of any of the terms in the legislative history of section 541 upon which respondents rely.[2]

Respondents admit that *Segal* did not involve corporations, but nevertheless they assert that "there is no reason to believe that the Court would have had any misgivings about treating carryforwards as property of a corporate debtor." Brief at 10. Without belaboring whether the *Segal* Court would or would not have had "misgivings" about extending its rationale to corporate taxpayers and to carryforwards (much less, to consolidated returns), the plain fact is that neither this Court, nor any other court, nor Con-

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[1] Carryforwards may be readily distinguished from carrybacks, which have been repeatedly construed to constitute a refund check from the IRS. As such, a carryback is no longer a "tax attribute" at all, but an "intangible" within the meaning of U.C.C. § 9-106. *See In re Kendrick & King Lumber, Inc.*, 14 B.R. 764 (Bankr. W.D. Okla. 1981) (*quoting* 11 U.S.C. § 541's legislative history to the effect that "property includes intangibles and the right to a refund under *Segal*)." *See also* Petition at 18-19. Like Congress, this Court itself described *Segal* as holding "that a business-generated loss carry*back* tax *refund*—which was based on prebankruptcy losses but received after bankruptcy—should pass to the trustee as . . . property." *Kokoszka* v. *Belford*, 417 U.S. 642, 646-47 (1974), citing section 70(a)(5) of the (then) Bankruptcy Act, 11 U.S.C. § 110(a)(5) (emphasis supplied).

[2] *See, e.g.*, Black's Law Dictionary (6th ed. 1990) defining "Intangible property," "Intangibles," and "Intangible asset." *See also* U.C.C. § 9-106. It is obviously a violation of the Internal Revenue Code to "traffic" in tax benefits as if they were property. *See generally* 26 U.S.C. §§269(a), 382. Clearly no such prohibition exists with respect to intangibles. And one would be fairly shocked to see future tax benefits described as having a "basis" or as being "amortized" or "depreciated," while intangibles clearly may be. *See* Treas. Reg. §§ 1.167(a)-3; 1.167(a)-6 (1991). Tax benefits are similarly to be strictly differentiated from the "rights" (copyrights, trade-marks, patents, e.g.) listed in the legislative history of 11 U.S.C. § 541.

gress in drafting section 541 and in codifying *Segal* into section 346, has ever made such extensions. PSS urges that the Court of Appeals was incorrect in doing so.[3] As discussed at pp. 17-21 of the Petition, when Congress codified *Segal*, it did *not* expand "property" in 11 U.S.C. § 541 to include NOL carryforwards, nor did it address how members of an affiliated group should allocate tax attributes on consolidated corporate returns. Instead, it added a subsection to 11 U.S.C. § 346, which provides a set of bankruptcy exceptions to the Internal Revenue Code. That subdivision addresses only what *Segal* addressed: an "individual" debtor. The legislative history plainly states that subdivision (i) "codifies the law of *Segal* . . . on carry*backs*" (emphasis supplied), just as the legislative history of section 541 states that the Code codifies *Segal* and makes "refunds" property of the debtor. *See* Petition at 19 & n.13. One may not simply ignore these words in the statute and its legislative history and construe subsection (i) to apply to corporations, much less to corporations filing consolidated corporate returns in which only the subsidiary is in bankruptcy.[4] That constitutes an unwarranted construction of subdivision (i) and a radical extension of *Segal*.

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[3] Respondents cite *Russell* v. *United States* (*In re Russell*), 927 F.2d 413, 417-18 (8th Cir. 1991) as authority for their position. *Russell*, however, like *Segal*, concerned an individual debtor, not a corporation. It should also be noted that the only authority cited by the *Russell* court for the proposition that an NOL carryforward is "property" for purposes of section 541 is the Bankruptcy Court's decision in *this* case.

[4] Thus, even if section 346(i) *did* apply to corporations and *did* equate tax attributes with "property," it would still not apply in a consolidated return case because the "tax attributes" referred to therein are not the subsidiary's but the parent's. As the legislative history states, while the estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case," it is also true that "[t]o the extent such interest is limited in the hands of the debtor, it is equally limited in the hands of the estate." 124 Cong. Rec. H. 11087, H. 11096 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards). As the *Western Pacific* cases make clear, since at the commencement of PLI's bankruptcy PSS had breached no fiduciary or contractual duty to PLI to provide the tax benefit of PLI's losses to PLI, the latter had no cognizable interest in such benefits.

Footnote continued on next page

With no other authority for the view that either section 541 or section 346(i) renders this NOL carryforward PLI's "property," respondents rely upon 11 U.S.C. § 346(h) and (j) and assert, based upon their readings of these two subsections: "*It could hardly be clearer* that the Bankruptcy Code contemplates that NOL carrybacks and carryforwards are *property* of the estate of a corporate debtor." Brief at 12 (emphasis supplied). This sweeping conclusion is insupportable for several reasons. First, a reading of section 346 as a whole (and of subsection (i) specifically) makes clear that Congress did *not* refer to NOL carryovers as "property," but rather as one of several "tax attributes" that result from a variety of tax-triggering transactions in "property." *See, e.g.*, subsections (g)(1) and (i)(1). "Tax attributes," that is, are clearly differentiated from "property" in section 346, rendering it impermissible—on this ground alone—to silently bootstrap NOL carryforwards back into section 541 as an "interest in property."

Nor do subsections (h) and (j) support respondents' suggested extension of *Segal* to apply to corporate taxpayers. The legislative history states, in relevant part:

> Subsection (h) provides that the creation of *the estate of an individual* under chapter 7 or 11 of title 11 as a separate taxable entity does not affect the number of taxable years for purposes of computing loss carryovers or carrybacks.

Committee on the Judiciary, United States Senate, to accompany S.2266, S. Rep. No. 989, 95th Cong., 2d Sess. 45-46 (1978) (emphasis supplied).[5] And subsection (j) deals solely with issues of State and local tax law.

Finally, section 346(a) expressly provides that *all* of section 346 is "subject to the Internal Revenue Code," including, presumably, the provisions regarding consolidated returns (26 U.S.C. §§ 1501-1504), the provision regarding worthless stock deductions (26 U.S.C. § 165), and the provision indicating that a cor-

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[5] Subsection (h) cross-references two other provisions, 11 U.S.C. §§ 728(a) and 1146(a) (1990), both of which deal solely with individual debtors.

poration is not treated differently for tax purposes because of its bankruptcy (26 U.S.C. § 1399).

Thus, nothing in section 346 provides support for the conclusion urged by respondents: that the section authorizes a bankruptcy court to declare the federal tax benefit of a corporate NOL carryforward generated by a bankrupt member of a consolidated group to be that member's "property" because it is in bankruptcy. It is the consolidated return regulations promulgated under the Internal Revenue Code,[6] and not the Bankruptcy Code, that apply to this NOL carryforward, and they allocate the benefit of that tax attribute to PSS, not PLI. *See* Treas. Reg. §§ 1.1502-77(a); 1.1502-21(b); 1.1502-12(h).

While respondents urge that the *Western Pacific* line of cases deal solely with state law, they in fact squarely hold, in the context of the bankruptcy of one member of a consolidated group:

> There is nothing in the [Internal Revenue] Code or Regulations that compels the conclusion that a tax saving must or should inure to the benefit of . . . the company which has sustained the loss that makes possible the tax savings.[7]

A parent of a consolidated group is not obliged—under either fiduciary or tax principles—to give to a subsidiary the benefit of an NOL carryforward that it generated, despite the latter's bankruptcy.[8] There is simply no provision in the Bankruptcy Code rendering the consolidated return provisions inapplicable in the bankruptcy context.

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[6] These regulations are "legislative in character" and "have the force and effect of law." *Union Electric Co. of Mo.* v. *United States*, 305 F.2d 850, 854, 158 Ct. of Cl. 479, 486 (1962) (citing authority).

[7] This passage, from *Western Pacific*, 197 F.2d at 1003-4, is quoted as authoritative in most of the opinions cited at page 14 of the Petition.

[8] As stated in *Western Pacific*: " 'the fact that one subsidiary contributes a particular income deduction to a consolidated return does not in itself entitle that subsidiary to the benefits of the reduced taxes resulting from the deduction . . . .' " See Petition at 13.

The parties also disagree on how the consolidated return regulations work. Respondents assert (at 6-7 n. 7) that those regulations allocate NOL carryforwards to the subsidiaries that generated them. This is plainly incorrect as a matter of law. First, respondents' primary authority for this novel suggestion is a proposed regulation, Prop. Treas. Reg. § 1.1502-20(g)(1)-(2), which was not in effect during the time period relevant herein. The tax benefit of an NOL carryforward generated by a subsidiary member of a consolidated group is automatically allocated to the common parent when the parent or the other members of the group have earned taxable income against which that NOL may be offset. Treas. Reg. §§ 1.1502-21(b); 1.1502-12(h). Thus, consistent with the regulation and with the *Western Pacific* cases construing the predecessor of this regulation, the NOL generated by PLI (which itself had no income) is available to PSS to offset income recognized by PSS or any other member of the consolidated group.

Respondents (at 7-8) also find support in 26 U.S.C. § 382 (*l*)(5). That provision, however, is not an exception to the consolidated return regulations, and does not address in any way how any competing claims for the NOL should be allocated among creditors and members of the consolidated group of which the debtor was a member. Clearly Congress could have provided for such an allocation, but it did not. Again, absent a clear direction from Congress that a special rule should apply in the bankruptcy context, the corporate tax provisions of the Internal Revenue Code apply.

Nor does it add anything to suggest (as respondents do at 9 n. 11) that another benefit of comprehensive congressional regulation, gate slots at airports, have been held by some courts to constitute "property" within the ambit of section 541. As pointed out at pp. 23-24 of the Petition, the court in *Pension Benefit Guaranty Corp.* v. *Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983) held that advantageous gate slots were *not*

"property" for bankruptcy purposes (at least at the time *Braniff* was decided) because they were merely an incidental (albeit a substantial and fully liquidated) benefit of federal regulation. The court in the later *In re Gull Air Inc.*, 890 F.2d 1255 (1st Cir. 1989) held gate slots to be no longer just a non-property "privilege" *because* (following a change in the applicable federal regulation in 1986) they constituted a "license" issued by the federal government that could (like "intangibles") be "bought, sold or leased for any consideration . . . ." *Id.* at 1260, *quoting* 14 C.F.R. § 93.221(a) (1989). The plain fact remains, however, that tax benefits may still not be bought and sold. *See* note 2 above. They thus constitute the greatest example of the same phenomenon presented by airport gate slots prior to 1986: an incidental (but non-"property") benefit to private parties resulting from comprehensive federal regulation.

Finally, in answer to PSS's assertion that the Bankruptcy Court had no jurisdiction, respondents rely upon the Court of Appeals' unprecedented conclusion that a bankruptcy court has jurisdiction to enjoin a non-bankrupt parent corporation from taking a worthless stock deduction with respect to its investment in a bankrupt subsidiary if doing so "interferes" with the tax benefit of an NOL carryforward, since that tax benefit constitutes the subsidiary's "property." This view prevails only if this Court construes this NOL carryforward to be PLI's "property" within the meaning of sections 541 and/or 346, and then further holds that a non-bankrupt unlawfully interferes with such "property," within the meaning of the automatic stay provision of the Bankruptcy Code (section 362), by filing a federal tax return which includes a tax deduction (here, a worthless stock deduction) which clearly is *not* the debtor's "property." PSS is under no legal obligation to "elect" foregoing the $38.9 million tax benefit arising from its long-term investment in PLI, in order to give PLI the tax benefit of an NOL carryforward that *itself* belongs not to PLI but to PSS.

CONCLUSION

Petitioner respectfully requests that the Court grant the Petition.

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APPENDICES

APPENDIX A

26 U.S.C. § 269(a)

§ 269. Acquisitions made to evade or avoid income tax

(a) In general.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purposes for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

APPENDIX B

Treas. Reg. § 1.1502-12(h)

Separate taxable income.

The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporation, subject to the following modifications:

* * *

(h) No net operating loss deduction shall be taken into account;

APPENDIX C

Treas. Reg. § 1.1502-21(b)

Consolidated net operating loss deduction.

* * *

(b) *Consolidated net operating loss carryovers and carrybacks*—(1) *In general.* The consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b). However, such consolidated carryovers and carrybacks shall not include any consolidated net operating loss apportioned to a corporation for a separate return year pursuant to paragraph (a) of § 1.1502-79, and shall be subject to the limitations contained in paragraphs (c), (d), and (e) of this section and to the limitation contained in § 1.1502-15.

(2) *Rules for applying section 172(b)(1)-(i) Regulated transportation corporations.* For purposes of applying section 172(b)(1)(C) (relating to net operating losses sustained by regulated transportation corporations), in the case of a consolidated net operating loss sustained in a taxable year for which a member of the group was a regulated transportation corporation (as defined in section 172(j)(1)), the portion, if any, of such consolidated net operating loss which is attributable to such corporation (as determined under paragraph (a)(4) of § 1.1502-79) shall be a carryover to the sixth taxable year following the loss year only if such corporation is a regulated transportation corporation for such sixth year, and shall be a carryover to the seventh taxable year following the loss year only if such corporation is a regulated transportation corporation for both such sixth and seventh years.

Appendix C

(ii) *Trade expansion losses.* In the case of a carryback of a consolidated net operating loss from a taxable year for which a member of the group has been issued a certification under section 317 of the Trade Expansion Act of 1962 and with respect to which the requirements of section 172(b)(3)(A) have been met, section 172(b)(1)(A)(ii) shall apply only to the portion of such consolidated net operating loss attributable to such member.

(iii) *Foreign expropriation losses.* An election under section 172(b)(3)(C) (relating to 10-year carryover of portion of net operating loss attributable to a foreign expropriation loss) may be made for a consolidated return year only if the sum of the foreign expropriation losses (as defined in section 172(k)) of the members of the group for such year equals or exceeds 50 percent of the consolidated net operating loss for such year. If such election is made, the amount which may be carried over under section 172(b)(1)(D) is the smaller of (a) the sum of such foreign expropriation losses, or (b) the consolidated net operating loss.

(3) *Absorption rules.* For purposes of determining the amount, if any, of a net operating loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net operating loss which is absorbed in a prior consolidated return year under section 172(b)(2) shall be determined by:

(i) Applying all net operating losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a pro rata basis, except that any portion of a net operating loss attributable to a foreign expropriation loss to which section 172(b)(1)(D) applies shall be applied last.

APPENDIX D

Treas. Reg. § 1.1502-77(a)

Common parent agent for subsidiaries.

(a) *Scope of agency of common parent corporation.* The common parent, for all purposes (other than the making of the consent required by paragraph (a)(1) of § 1.1502-75, the making of an election under section 936(e), the making of an election to be treated as a DISC under § 1.992-2, and a change of the annual accounting period pursuant to paragraph (b)(3)(ii) of § 1.991-1) shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. Except as provided in the preceding sentence, no subsidiary shall have authority to act for or to represent itself in any such matter. For example, any election available to a subsidiary corporation in the computation of its separate taxable income must be made by the common parent, as must any change in an election previously made by the subsidiary corporation; all correspondence will be carried on directly with the common parent; the common parent shall file for all extensions of time including extensions of time for payment of tax under section 6164; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each subsidiary in the group; notice and demand for payment of taxes will be given only to the common parent and such notice and demand will be considered as a notice and demand to each subsidiary; the common parent will file petitions and conduct proceedings before the Tax Court of the United States, and any such petition shall be considered as also having been filed by each such subsidiary. The common parent will file claims for refund or credit, and any refund will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any

such subsidiary; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such subsidiary. Notwithstanding the provisions of this paragraph, any notice of deficiency, in respect of the tax for a consolidated return year, will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice of deficiency as to the other members); any notice and demand for payment will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice and demand as to the other members); and any levy, any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the district director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.